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EUROPE

Soft Landing in Crosswinds for a Lasting Recovery

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Executive Summary

A soft landing for Europe's economies—bringing inflation back to target with a moderate economic cost in terms of growth—is within reach, but crosswinds could make it difficult to achieve price stability while securing a lasting recovery.

Over the next few quarters, cooling yet still-strong labor markets are expected to support real income growth and consumption. The recovery of consumption will help offset the effects of the needed withdrawal of fiscal support and galvanize investment as monetary policy eases. Against the backdrop of gradually strengthening private demand, durable disinflation will require a rebound in labor productivity, with profit margins returning to precrises levels. In advanced European economies, risks to the soft landing are balanced. For many economies in the Central, Eastern, and Southeastern Europe (CESEE) region, risks are one-sided amid still-high wage growth, stickier core inflation, and persistently high inflation expectations.

Delivering a soft landing is not the only task that needs urgent attention. Europe's per capita income levels are well behind the global frontier, and this gap is not expected to close over the forecast horizon. Productivity growth has slowed, and aging is a major drag. The CESEE region, where private investment was already low before the pandemic and Russia's invasion of Ukraine, has seen relative wage levels rising, pressuring competitiveness. Across the continent, geoeconomic fragmentation is casting a shadow on old growth models. At the same time, rising long-term expenditure pressures due to aging populations, climate ambitions, and ramped-up defense spending call for structural fiscal reforms and add to the urgency of raising growth sustainably.

Meeting these challenges will not be easy. Yet Europe has shown it can overcome even the most severe obstacles when acting decisively and together. With the right policies, policymakers can secure the soft landing and raise medium-term growth prospects.

The pace of *monetary policy* easing needs to match the evolution of underlying inflationary forces. In advanced European economies, a gradual, measured pace of easing is preferable under the baseline, ensuring that monetary conditions do not loosen too fast or too slowly. Many CESEE economies will need to maintain a tight stance for longer to fully rein in inflation. *Fiscal* support from the crises should be fully withdrawn in most of Europe, as shocks continue to fade and economies recover, without undermining public investment and social protection systems. Together with fiscal reforms, consolidation will strengthen fiscal sustainability, rebuild buffers against downside risks that would activate automatic stabilizers, and help create space to address spending needs related to aging, climate, and defense. In some countries, especially in the CESEE region, a less expansionary fiscal policy will help avoid further erosion of competitiveness. Property sector stress and rising bankruptcies could lead to larger-than-expected increases in nonperforming loans. Banks will need capital buffers strong enough to withstand an increase in nonperforming loans while, at the same time, leaving them in a position to support the projected increase in investment. Where pockets of financial vulnerabilities warrant tightening, care should be taken to avoid migration of risks to less-regulated nonbank financial institutions.

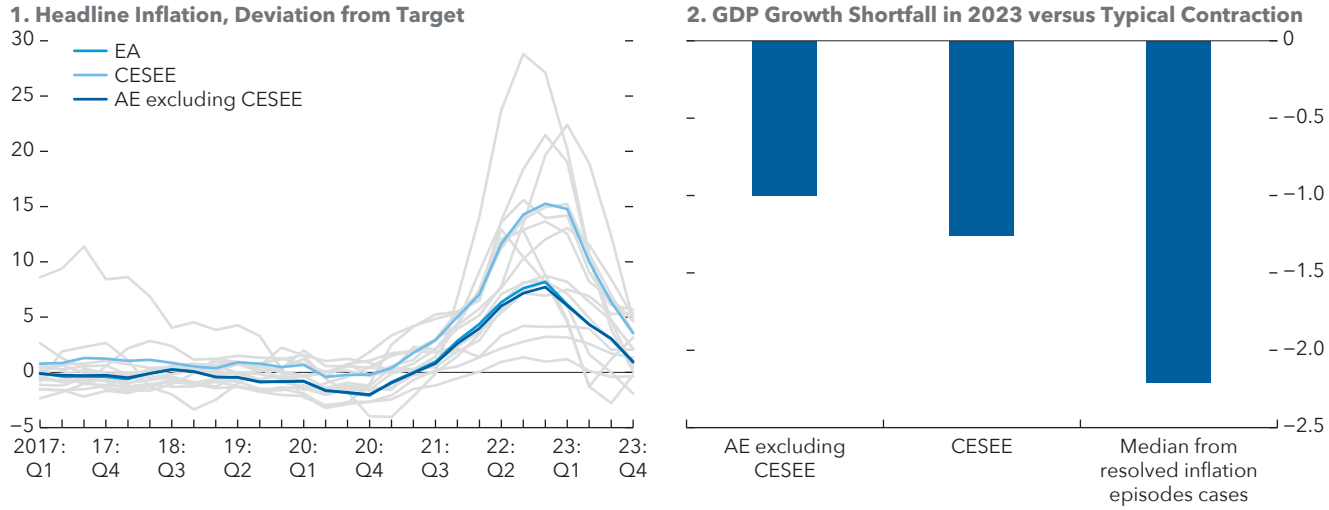
Raising potential growth prospects calls for efforts at both the domestic and European levels. Measures should aim to raise labor force participation, prepare the workforce for looming structural shifts, set an enabling environment for private investment, and promote innovation on a level European playing field—especially when it comes to the green transition, including through a strong commitment to carbon pricing. Greater European integration would amplify the effect of these reforms. Formulating an ambitious set of growth-enhancing reforms should be a key priority of a new EU commission. Working together, EU member countries could substantially lift per capita incomes by addressing the remaining internal barriers that hamper the single market. Better capital allocation will require completing the banking and capital markets unions. Measures would include greater harmonization of national rules on taxes and subsidies, improving insolvency regimes, and reducing administrative burdens. There is also further room to lower effective barriers to labor mobility, and to goods and services trade.

Soft Landing in Crosswinds for a Lasting Recovery

A Soft Landing Is Within Reach but Not Assured ...

A soft landing is within reach. Inflation rates in Europe have fallen to approximately one-third of the multidecade peaks of the end of 2022. The cost of disinflation, in terms of a cyclical slowdown in growth, has so far been mild compared to the drops in activity typically required to successfully resolve inflationary episodes. This is the case in advanced European economies and the Central, Eastern, and Southeastern Europe (CESEE) region (Figure 1).

Figure 1. A Soft Landing Is Within Reach
(Percentage points)

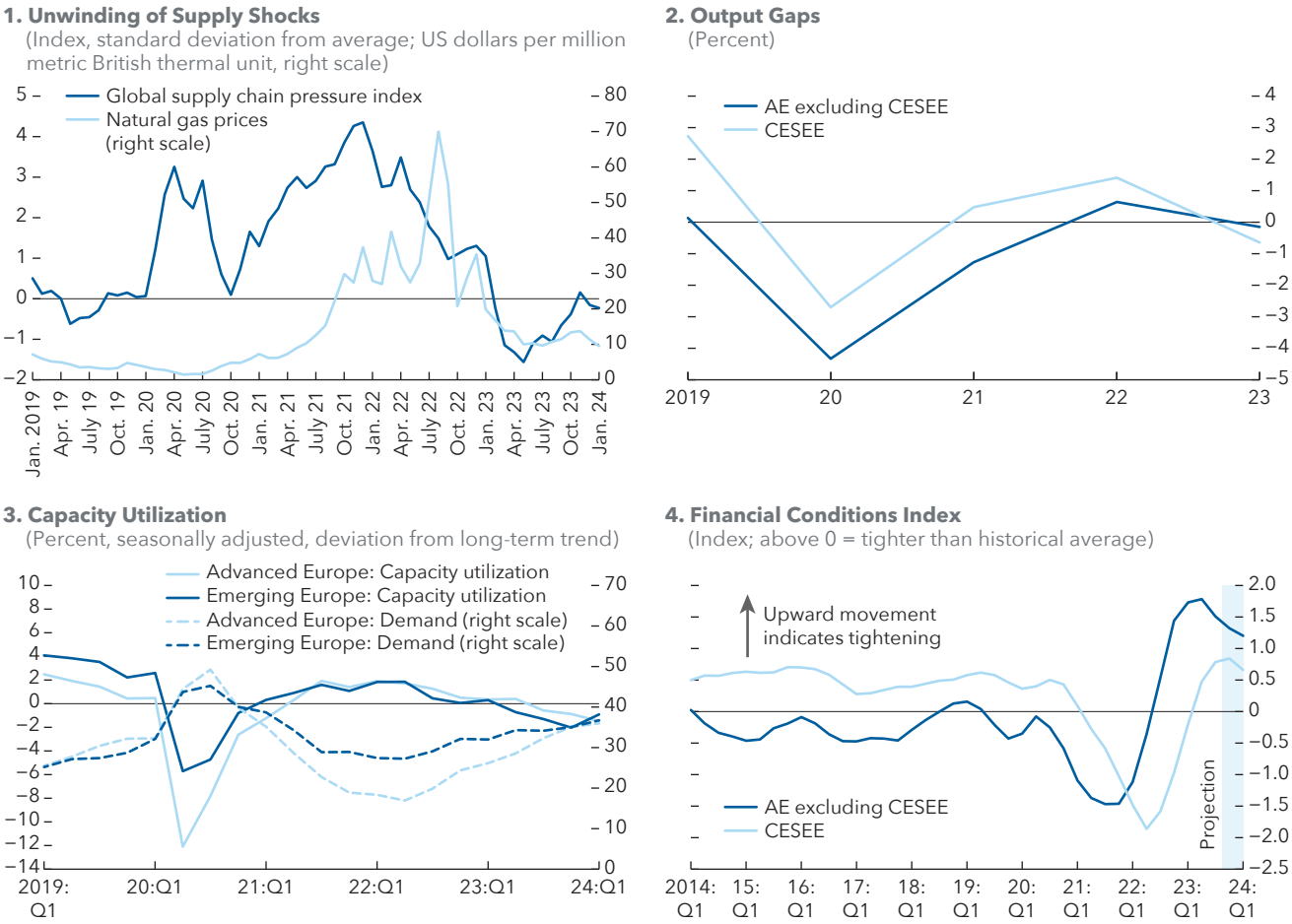


Sources: Central bank statistics; IMF, World Economic Outlook database; and IMF staff calculations.
Note: In panel 1, CESEE includes Belarus, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Moldova, Poland, Romania, Serbia, Slovak Republic, Slovenia, and Ukraine. AE excludes CESEE and includes Austria, Belgium, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Luxembourg, Malta, The Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. Panel 2 shows median GDP growth rates in 2023, minus 2013–19 averages, compared to the average two-year relative contraction in successful inflation fighting episodes in Ari and others (2023). AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe; EA = euro area.

The fast disinflation reflects both the unwinding of adverse supply shocks and the effectiveness of monetary policy in restraining demand (Figure 2). High interest rates, which have peaked in most countries after unprecedented tightening, have contained demand. Indications are that the speed and strength of transmission to output and prices are consistent with historical averages. Financial conditions tightened significantly, peaking between late 2022 (in advanced economies excluding CESEE) and mid-2023 (in CESEE). There are recent signs of moderation as lending standards are no longer tightening and credit demand is bottoming out from very weak levels. Positive output gaps narrowed and are now estimated to be negative in some countries. Adverse global

This report was prepared by Oyun Adilbish, Xiangming Fang, Shakill Hassan (lead), and Ben Park, under the guidance of Diego Cerdeiro and the supervision of Helge Berger and Stephan Danninger. It includes contributions from Nathaniel Arnold, Chikako Baba, Guillaume Claveres, Geoffroy Dolphin, Stephanie Eble, Philipp Engler, Gianluigi Ferrucci, Alina Iancu, Claire Li, Gösta Ljungman, Giacomo Magistretti, Augustus Panton, Alexander Pitt, and Sebastian Weber. Agnesa Zalezakova was expertly in charge of administrative and editorial support.

Figure 2. Demand and Supply Conditions



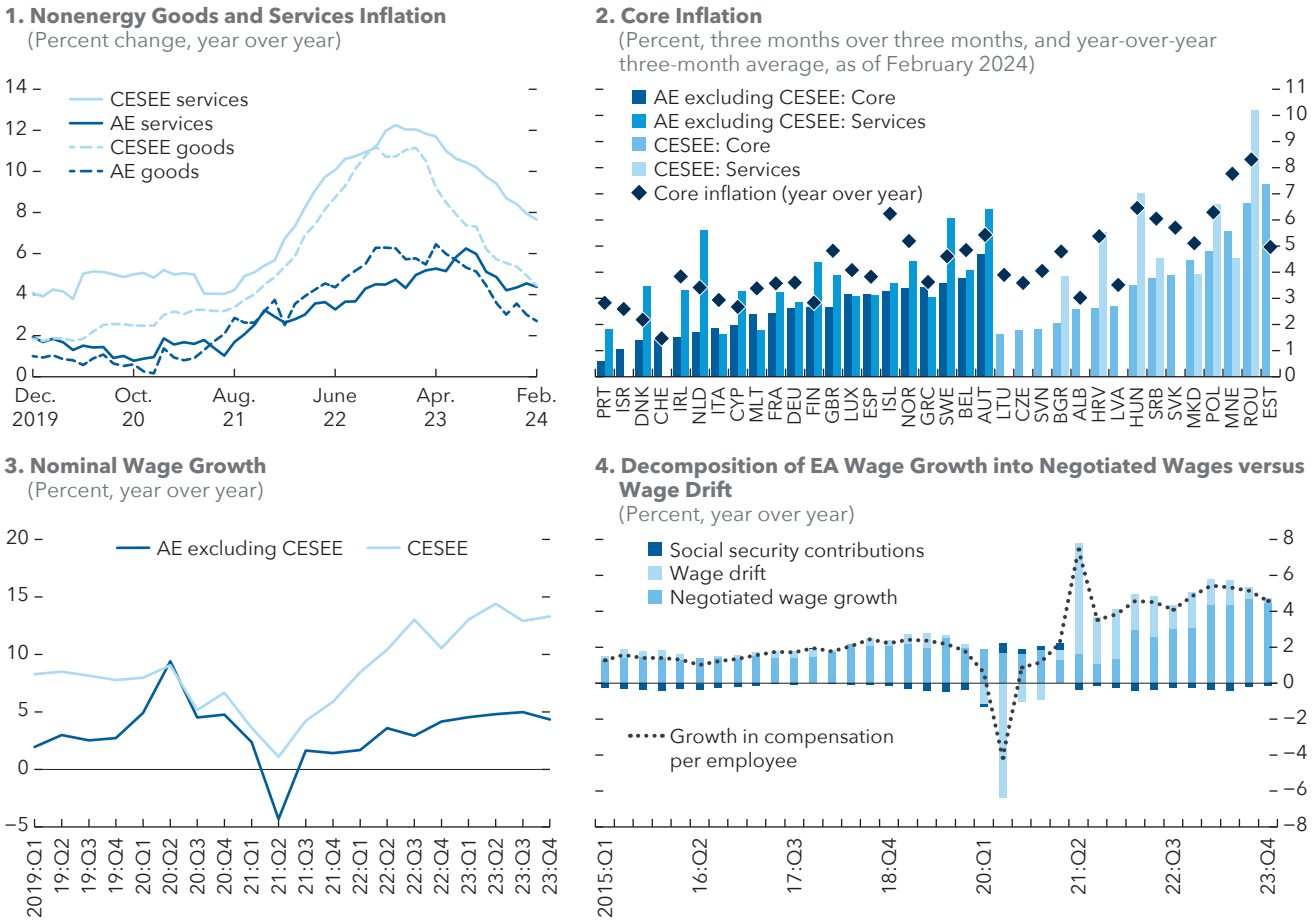
Sources: Borraccia and others (2023); Federal Reserve Bank of New York; Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.
Note: In panel 2, CESEE exclude Albania, Belarus, Kosovo, North Macedonia, Montenegro, Russia, Serbia, Türkiye, and Ukraine. In panel 3, advanced EU excludes Ireland. In panel 4, the financial conditions indexes show change in the index from previous quarter. The financial conditions indexes are aggregated using liability-weighted average. The financial conditions indexes for 2023:Q4 and 2024:Q1 show projected value. AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe.

and regional supply shocks unwound. The supply normalization lessened the restraint on demand needed to slow price pressures. Despite geopolitical risks to global shipping routes and energy markets, supply-chain pressures and energy prices are around prepandemic levels.[1]

Disinflation, however, has been uneven. Core inflation in year-on-year terms—the time horizon matching typical central bank targets—is substantially higher and more persistent in CESEE (Figure 3, panel 1). While in sequential terms core inflation has decelerated significantly, this is largely driven by core goods. Services inflation remains strong for many in CESEE (for example, Hungary and Romania; Figure 3, panel 2), where nominal wage growth is also stronger (Figure 3, panel 3). In Türkiye, while the economy has remained resilient, inflation is still high.

[1] After a trough in September 2022, as of December 2023 the euro area's goods terms of trade improved back to prepandemic levels. The reversal was driven mainly by the decline in the import price index of mineral fuels (which has fallen by 38 percent between June 2022 and February 2024). The shift to liquified natural gas implies higher costs from liquefying and shipping (in the order of about $6 per one million British thermal units). As a result of weak demand (including due to mild weather) and ample inventories, however, European gas prices have recently fallen. As of March 19, natural gas prices were of EUR28.8 per megawatt hour, 8 percent higher than the 2021:Q1–22:Q3 average and (as a result of price volatility in 2021) 40 percent lower than the 2021 full-year average.

Figure 3. Inflation and Wage Developments



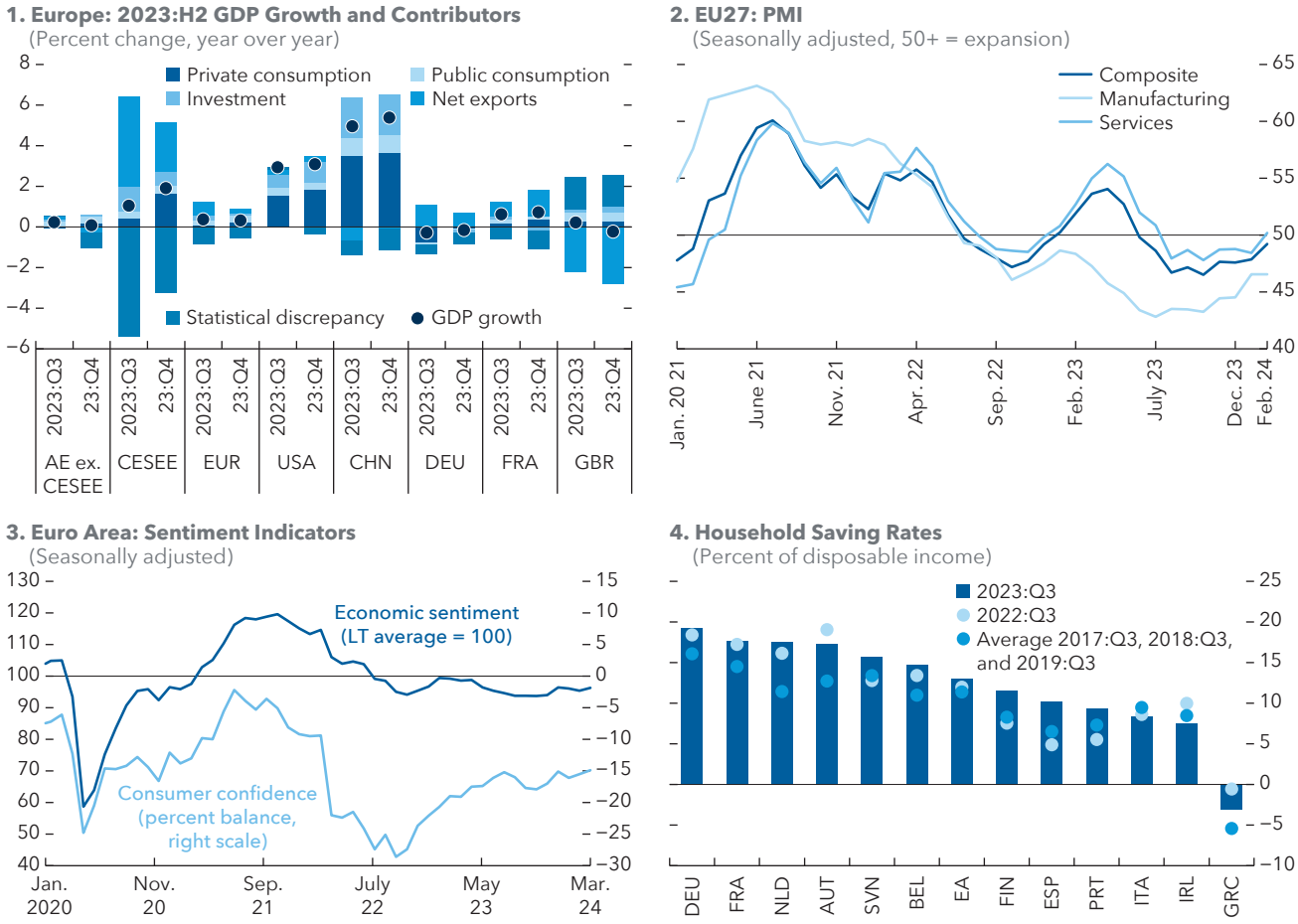
Sources: Central bank statistics; Haver Analytics; and IMF staff calculations.
Note: In panel 1, AE includes Denmark, France, Germany, Sweden, and the United Kingdom. CESEE includes Belarus, Bulgaria, Croatia, Czech Republic, Hungary, Moldova, Montenegro, North Macedonia, Poland, Romania, and Serbia. In panel 3, CESEE includes Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia. AE excludes CESEE countries and includes Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, The Netherlands, Norway, Portugal, Spain, and Sweden. Country abbreviations are International Organization for Standardization (ISO) country codes. AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe; EA = euro area.

Underlying pressures remain notably strong in some advanced European economies (for example, Iceland and Norway), but are weak in others (Switzerland). Overall wage growth remains robust across advanced European economies, even as wage drift is falling (Figure 3, panel 4).[2]

While economic activity is bottoming out, the recovery is so far very tentative in most economies. Growth outturns in the second half of 2023 were somewhat lower than expected in the October 2023 *World Economic Outlook* projections (Figure 4, panel 1). The feeble recovery reflects weak consumer sentiment, the lagged effect of higher energy prices, and weakness in interest-rate-sensitive manufacturing and business investment (Figure 4, panels 2 and 3). While real incomes started to increase year over year in some economies, low confidence led to weaker private consumption than expected in both advanced European economies (for example, Germany and the United Kingdom) and in CESEE (for example, Czech Republic, Poland, and Romania). With few exceptions, household saving rates—already high in 2022 compared to precrises—increased further in 2023

[2] Wage drift is defined as the difference between growth in compensation received and growth in negotiated wages. Negotiated wages tend to be fixed for some time and lag developments in activity.

Figure 4. Economic Activity



Sources: Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.
Note: In panel 1, GDP growth is on the basis of SWDA data. Investment is gross fixed capital formation and therefore excludes inventories. Countries that do not have a full range of data for GDP decomposition in quarterly frequencies are excluded from the panel. In panel 4, savings is calculated as gross disposable income minus final consumption expenditure. Country abbreviations are International Organization for Standardization (ISO) country codes. EU27 includes Austria, Belgium, Bulgaria, Croatia, Republic of Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and Sweden. AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe; EA = euro area; EUR = Europe; LT = long term; PMI = purchasing managers' index.

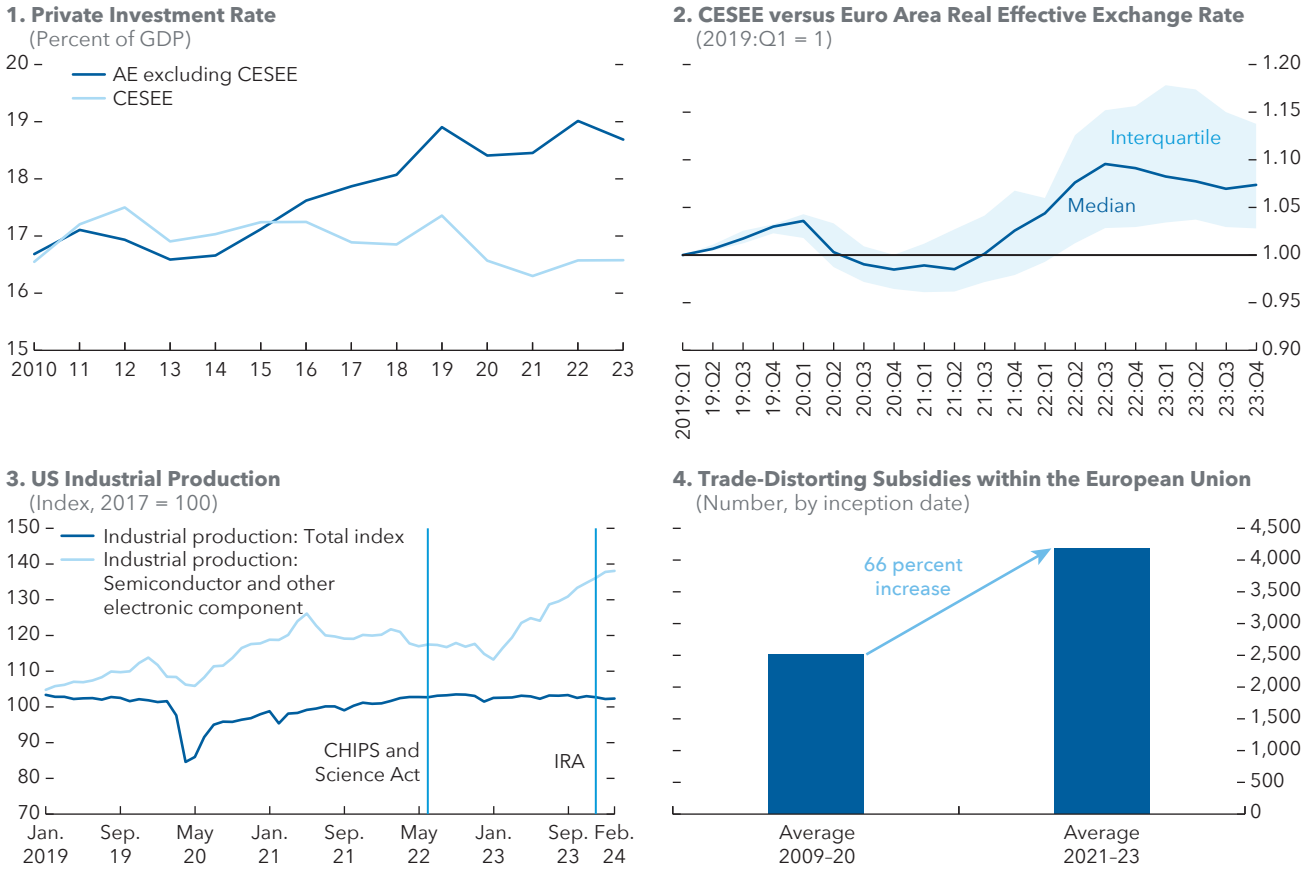
(Figure 4, panel 4). In the euro area, cumulative excess savings since the first quarter of 2020 are estimated at about 7½ percent of GDP as of 2023:Q3 (up from around 7 percent a year earlier). Supply-chain normalization has led to inventory destocking in some countries (Czech Republic, Italy, Poland), making a dent on growth.

The normalization of supply chains also reflects, in part, weaker demand for goods, including from China and the United States. The flip side is that countries more reliant on services continued to outperform (Italy and Spain, which benefited from tourism).

… and Old Challenges Become More Pressing

Beyond the soft landing, medium-term growth prospects are dimming. The weakening of medium-term growth is a global phenomenon (see Chapter 3 in the April 2024 *World Economic Outlook*), but Europe faces unique challenges. While labor markets do not evince scarring and emigration pressures have eased in some CESEE

Figure 5. Marks from the Crises and Materializing Structural Shifts



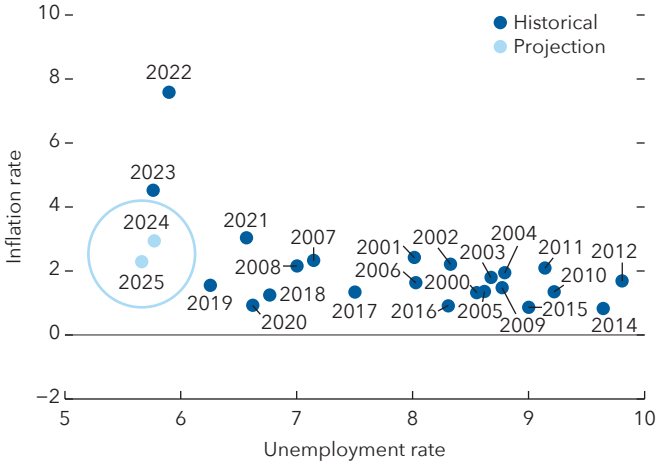
Sources: Federal Reserve Bank of St. Louis; Global Trade Alert Database; Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.
Note: In panel 1, investment rate is in nominal terms. AE excluding CESEE excludes Cyprus, Denmark, Malta, Norway, San Marino, Spain, and Sweden, and CESEE excludes Belarus, Bosnia and Herzegovina, Hungary, North Macedonia, Russia, Türkiye, and Ukraine. In panel 2, CESEE includes Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovak Republic, Slovenia, and Türkiye. AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe; CHIPS = Creating Helpful Incentives to Produce Semiconductors; IRA = Inflation Reduction Act.

economies (at least temporarily, and in large part due to emigration from Ukraine[3]), aging will continue to act as a major drag. Moreover, technological changes (for example, from artificial intelligence) may increasingly require the working population to develop new skills. In CESEE, private investment was already low before the crises. In many economies, it has fallen further since (for example, Croatia), weighing on the region's potential growth (Figure 5, panel 1). And the long period of high inflation relative to trading partners is starting to put pressure on external competitiveness (Figure 5, panel 2). Nearshoring forces are increasingly a reality around the world. There are notable rises in the domestic capacity of major trading partners amid subsidies to incentivize specific sectors (Figure 5, panel 3).[4] While nearshoring may be beneficial for some smaller European economies that benefit from trade and foreign direct investment diversion, it can lower aggregate income levels in Europe (Baba and others 2023). An uncoordinated policy response to structural pressures such as trade fragmentation—the splintering of countries into blocs that trade mostly with each other—could fray the European Union's single market. By one estimate, the number of subsidy measures imposed by EU countries that harm other EU members has increased by well over 50 percent since the onset of the crises (Figure 5, panel 4). And while the quest for

[3] See Box 5 for an update on Ukraine.

[4] See Gopinath and others (2024) for evidence of global geoeconomic fragmentation, and Fletcher and others (forthcoming) for evidence on how geopolitical tensions are reshaping Germany's foreign direct investment.

Figure 6. Europe: Observed Phillips Curve
(Annual inflation rate versus unemployment rate)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: Inflation rate is the year-over-year change in Core Consumer Prices. Europe excludes Russia and Türkiye.

higher productivity may have become more challenging, sustainable, productivity-driven growth might be even more necessary to support the green transition and meet security needs.

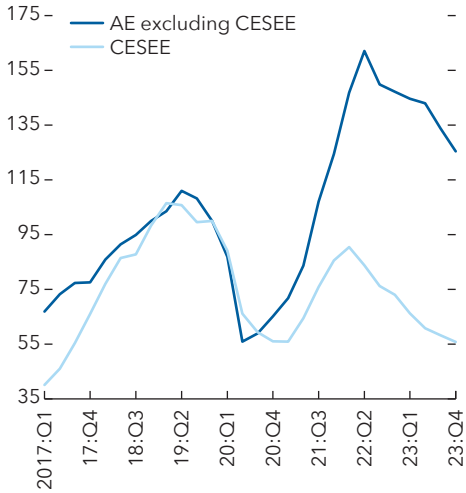
Outlook: What Needs to Go Right in the Near Term

A slow, low-inflation recovery is the IMF staff's baseline. The expected gradual recovery of activity alongside disinflation toward targets—a somewhat unusual configuration (Figure 6)—rests on strong assumptions. Labor markets need to be neither too strong nor too weak, consumption has to pick up, and investment needs to follow as financial conditions ease. The recent normalization of supply conditions, which allowed inflation to cool with little impact on labor markets, has to remain intact. And the combination of still-tight monetary policy and gradual fiscal consolidation has to ensure that the path of inflation stays within central banks' comfort zones.

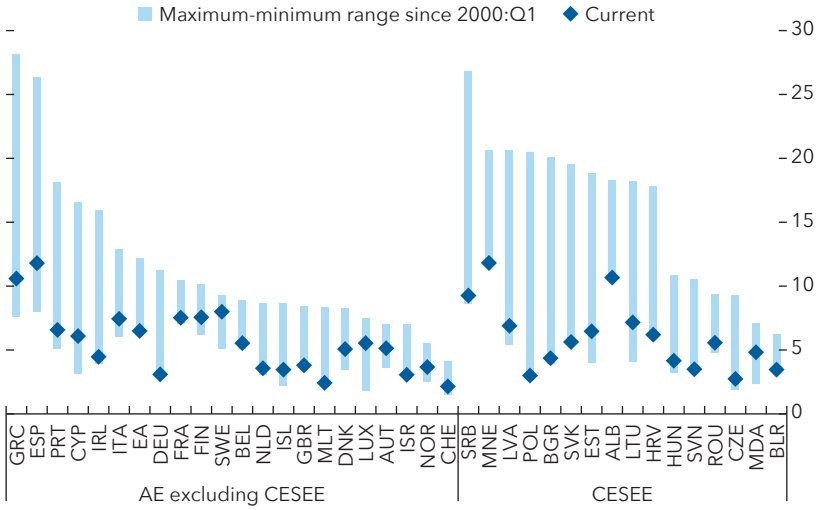
Labor markets are forecast to ease but remain strong enough to support real income growth and consumption as inflation slows. A continuation of the trends observed through the end of 2023, with the number of vacancies falling but unemployment remaining low (Figure 7), would lead to healthy, albeit slowing, wage growth. Rising real incomes will also help to balance wealth effects from falling housing prices.

Figure 7. Labor Market Tightness

1. Vacancy-to-Unemployment Ratio
(Index, 2019:Q4 = 100)

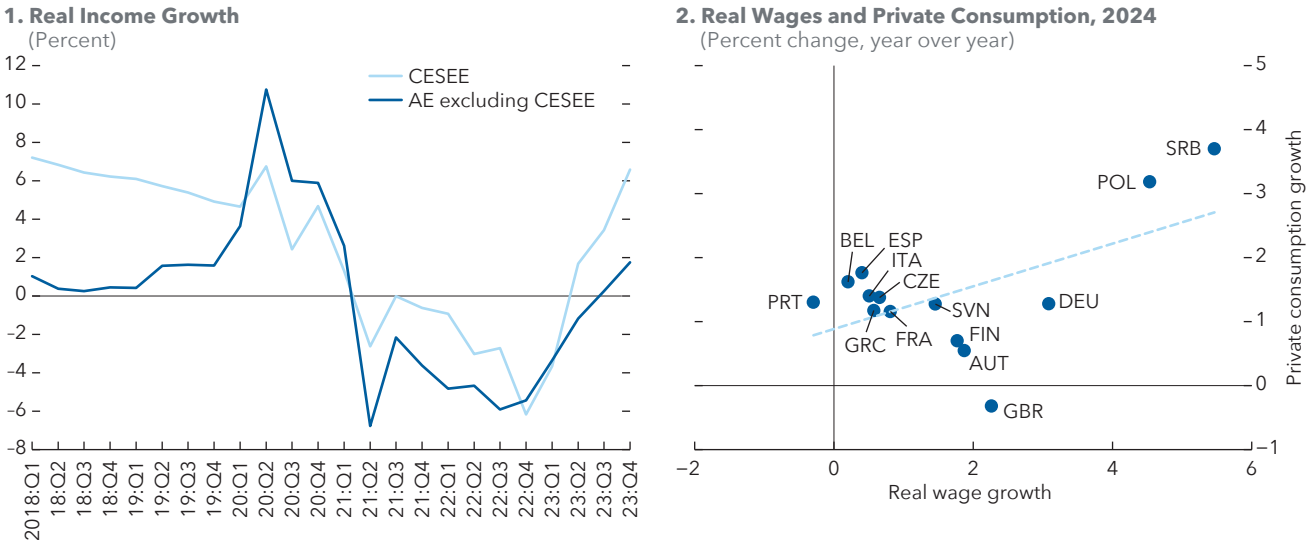


2. Unemployment Rate, 2023:Q4 or Later
(Percent)



Sources: Eurostat; Haver Analytics; and IMF staff calculations.
Note: In panel 1, AE excludes CESEE includes Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Ireland, Luxembourg, Malta, The Netherlands, Norway, Portugal, Spain, Sweden, and Switzerland. CESEE includes Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, North Macedonia, Poland, Romania, Slovak Republic, and Slovenia. Country abbreviations are International Organization for Standardization (ISO) country codes. AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe.

Figure 8. Real Income Growth



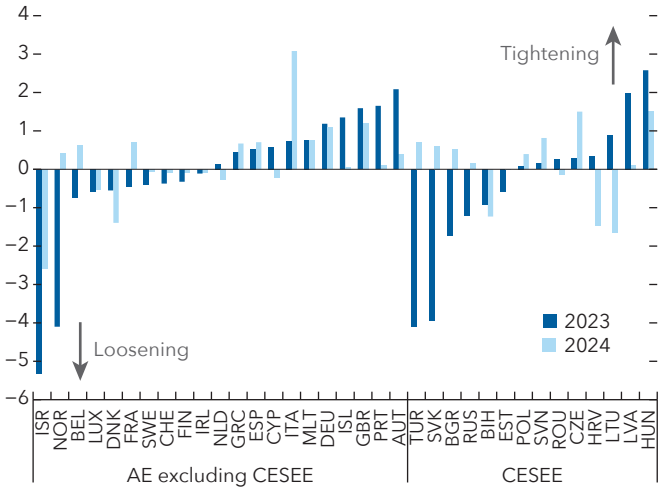
Sources: Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.
Note: In panel 1, AE excluding CESEE excludes Iceland, Israel, San Marino, and Switzerland. CESEE includes Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia. Country abbreviations are International Organization for Standardization (ISO) country codes. AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe.

The resulting rebound in private consumption will support growth throughout 2024 (Figure 8). Despite stronger growth in some trading partners (the United States, in particular), the contribution from net exports will generally decrease in 2024 as the pickup in domestic demand leads to a gradual increase in imports. Fiscal policy is expected to contribute negatively to growth because of the warranted withdrawal of support (Figure 9).

In advanced economies, investment is expected to pick up in 2025 as monetary policy stances return to neutral and financial conditions continue to ease. Private investment in advanced economies is expected to remain flat in 2024 but increase notably in 2025. In many CESEE economies, on the other hand, growth will rely more and for longer on consumption, because higher wage growth will require tight monetary stances for longer. Consequently, beyond a cyclical rebound from the 2023 trough, investment in CESEE countries is expected to take somewhat longer to recover (Figure 10, panel 1).

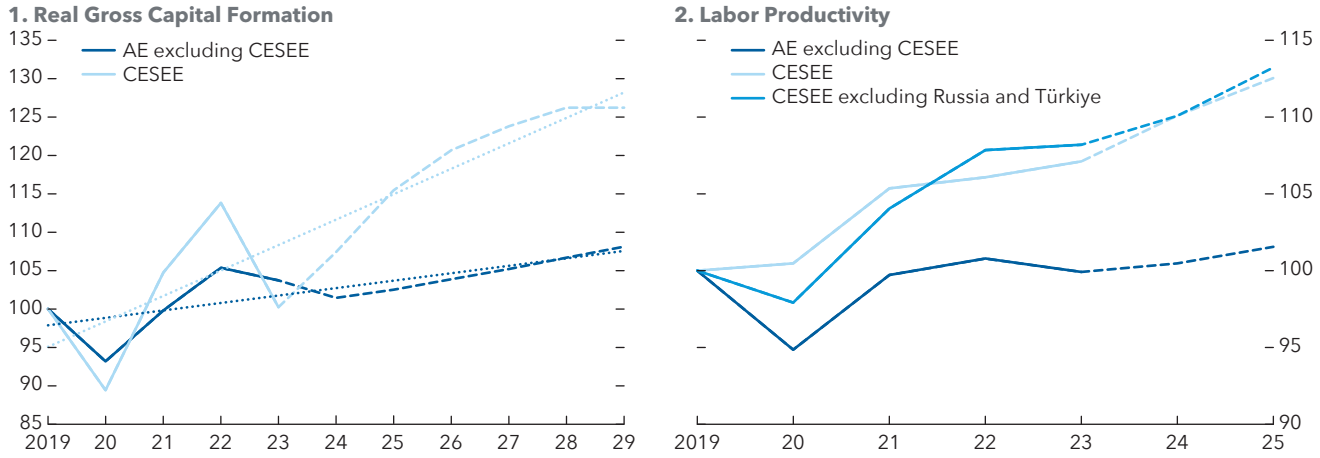
Inflation will fall toward targets even as demand recovers. This configuration rests on inflation expectations remaining anchored, and that the recovery in labor productivity—after a years-long plateau (Figure 10, panel 2)—and muted profit growth will mitigate the effects of rising wages on inflation.

Figure 9. Change in Cyclically Adjusted Primary Balance
(Percent of potential GDP)



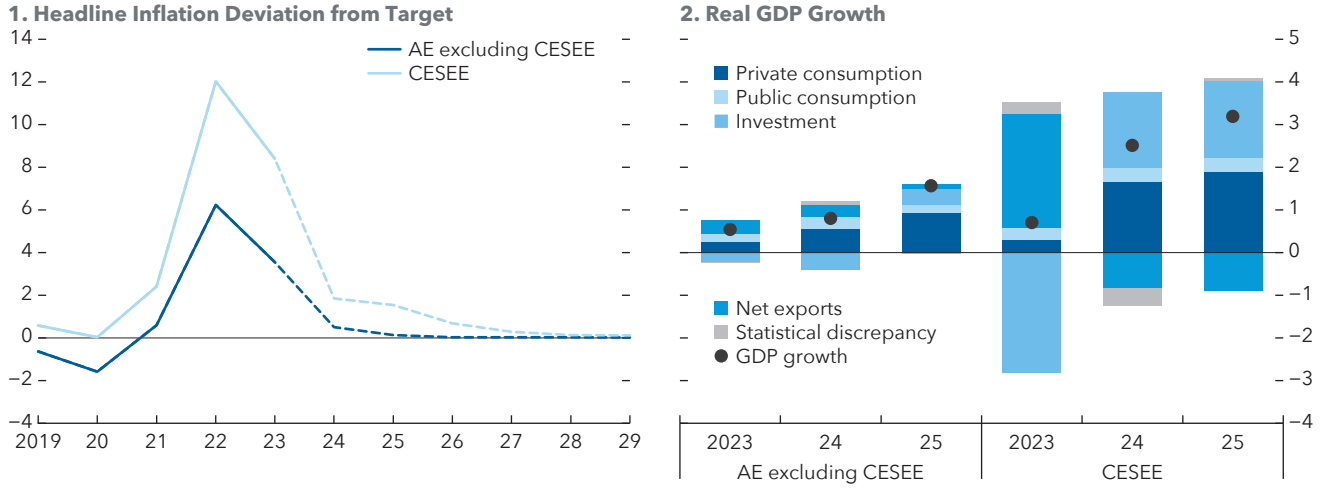
Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes. AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe.

Figure 10. Investment and Labor Productivity
(Index, 2019 = 100)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: In panel 1, CESEE excludes North Macedonia, Russia, and Türkiye. In panel 2, CESEE excludes Kosovo and Montenegro. AE excludes CESEE and San Marino. AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe.

Figure 11. Inflation and Growth Projections
(Percent change; year over year)



Sources: Central bank statistics; IMF, World Economic Outlook database; and IMF staff calculations.
Note: In panel 1, AE excludes CESEE and San Marino. CESEE excludes Bosnia and Herzegovina, Bulgaria, Kosovo, Montenegro, North Macedonia, Russia, and Türkiye. In panel 2, CESEE excludes Belarus, Russia, Türkiye, and Ukraine. Investment is gross capital formation and therefore includes inventories. AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe.

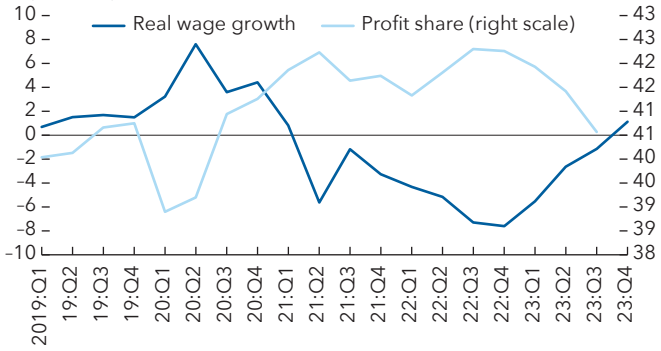
Under these conditions, the baseline is for a soft landing for most economies. Advanced and emerging market European economies are expected to grow by 0.8 and 2.9 percent in 2024 and 1.6 and 3.5 percent in 2025, respectively. Inflation will return to target in 2025 in most advanced European economies and in late 2026 in most emerging European economies (Figure 11).

There is no shortage of crosswinds that could get in the way:

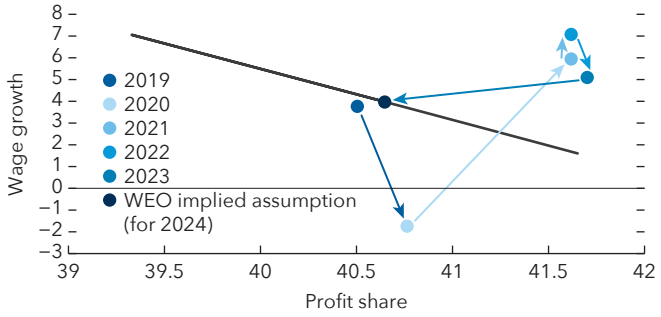
- In *advanced European economies*, the soft landing could be undone by a failure of consumption—and in turn investment—to pick up, as weak sentiment lingers. Weak domestic demand could, in turn, lead to inflation undershooting targets. Growth can also surprise on the upside if there is a swift recovery in consumer confidence amid persistently high wage growth. Alongside less profit compression than in the baseline, this configuration would lead to higher-than-expected inflation (Figure 12, panels 1 and 2).
- Persistently high inflation, requiring tighter monetary policy stances that ultimately lead to lower growth, is the main risk for many *CESEE economies*. While IMF staff models predict moderating wage pressures in CESEE (Figure 12, panel 3), wage growth remains high—at 12.1 percent in the fourth quarter of 2023. High wage growth could add to the persistence of core inflation, forcing central banks to keep monetary policy tight for longer than projected. Tighter monetary policy would be warranted to mitigate the risk of expectations de-anchoring but would lower growth. Weaker-than-expected investment (for example, because consumption is too slow to recover or slow fiscal consolidation crowds out corporate credit demand by pushing up yields above the baseline) would exacerbate the slump in such a downside scenario.
- Across the region, a possible escalation of Russia's war in Ukraine or a broadening of the conflict in Middle East could raise uncertainty and affect supply chains and commodity prices.[5]

Figure 12. Wages and Profits

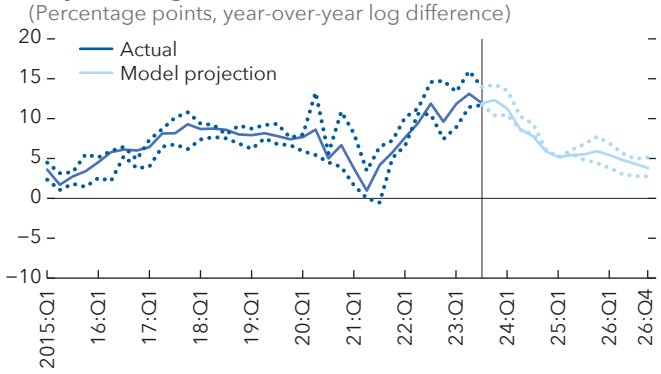
1. Real Wages and Profit Share
(Percent)



2. Combinations of Wage Growth and Profit Share Consistent with Inflation Projections
(Percent)



3. Projected Wage Growth in CESEE
(Percentage points, year-over-year log difference)



Sources: Consensus Economics; Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.
Note: In panel 1, profit share is measured by gross operating surplus over gross value added. Panel 2 is based on Hansen, Toscani, and Zhou (2023). The straight-line marks profit share-wage growth combinations consistent with the inflation projection for 2024. The figure shows sectoral aggregate of euro area. In panel 3, the solid lines report the purchasing-power-parity GDP-weighted average of observed and projected wage growth across countries. The dashed lines report the interquartile range of the (projected) wage growth across CESEE countries. CESEE = Central, Eastern, and Southeastern Europe; WEO = *World Economic Outlook*.

[5] Based on empirical estimates of pass-through from shipping prices to inflation (Carrière-Swallow and others 2022), the impact of the rise in shipping costs through the end of February has been modest, at about 20 basis points for core price levels.

Medium-Term Challenges Await Beyond the Soft Landing

Low potential growth remains Europe's Achilles' heel. On the back of rising integration, advanced European economies had managed to close the productivity gap with the United States in the second half of the 20th century. The gap opened up again in the early 2000s (Figure 13, panel 1).[6] From 2010 to 2022, Europe's per capita income grew at the same rate as the United States, leaving average per capita income levels in purchasing-power-parity terms in Europe around one-third lower than in the United States. The income gap to the global frontier extends across the region (Figure 13, panel 2). For example, with the exception of Ireland and Luxembourg, per capita incomes in all of the EU advanced economies are now lower than in the United States.[7] Even with a successful soft landing in the near term, the large distance to the global frontier is not expected to narrow over the forecast horizon (Figure 13, panel 3).

Medium-term prospects have also weakened relative to the past and are increasingly reliant on productivity growth, which is falling (Figure 13, panel 4). Demographics already barely contribute to medium-term growth prospects, as populations age, and there is a secular decline in hours worked in Europe (Astinova and others 2024). Net migration has recently increased in many economies, in large part because of the inflow of Ukrainian refugees, yet challenges to improve integration of immigrants (including refugees) into labor markets remain. The result is that, for most economies, medium-term growth is expected to rely increasingly on productivity growth, which can be weighed down further by fragmentation pressures and how Europe responds to them. Productivity growth will be especially critical in CESEE where the crises and their fallouts resulted in loss of price competitiveness, and investment rates are lower and recovering more gradually.[8]

Policies to Secure the Soft Landing and Lift Medium-Term Growth

Executing the soft landing will require careful monetary policy calibration. Fiscal support from the crises needs to be withdrawn in most of Europe as shocks continue to fade in order to strengthen sustainability, make room to accommodate longer-term budget pressures, and avoid crowding out private investment. Macroprudential policies should ensure banks have capital buffers that are robust to larger-than-expected increases in nonperforming loans (NPLs), while allowing credit to continue to flow as investment picks up. Raising potential growth prospects calls for efforts at both regional and domestic levels—including tackling remaining barriers to the European Union's single market and undertaking domestic reforms to improve business dynamism, ease demographic constraints, and prepare for looming and materializing structural shifts.

Monetary Policy: Calibrate Carefully amid Two-Sided Risks

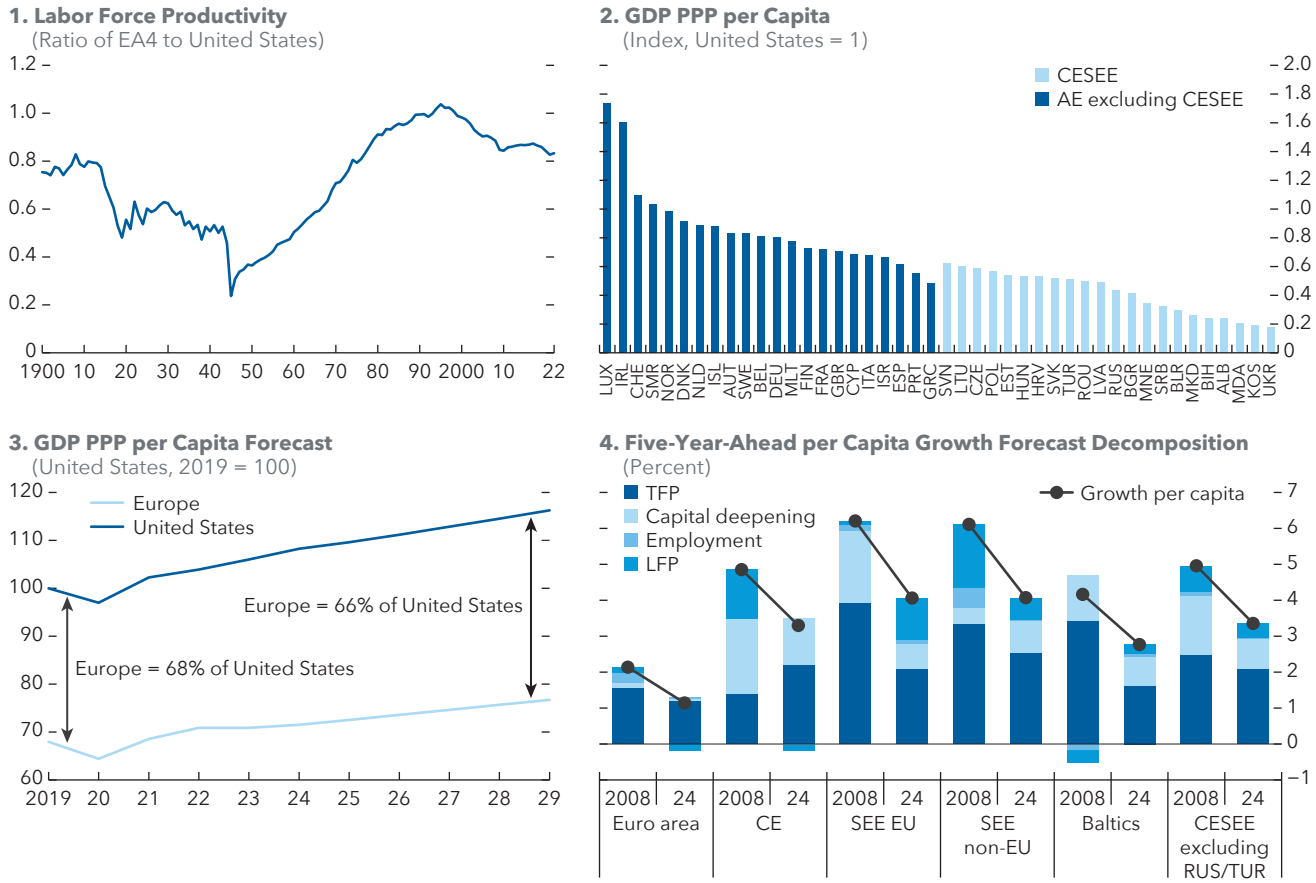
Monetary policy stances are still appropriately tight in most of Europe. Central banks are expected to start or continue to ease rates. While most central banks have stopped hiking policy rates, and some started their easing cycle (for example, Czech Republic, Hungary, Israel, and Switzerland), policy rates remain generally above estimates of neutral rates (Figure 14, panel 1). Interest rate gaps and Taylor rule estimates show substantial variation in the degree of monetary policy tightness (Figure 14, panel 2). In general, however, policy rates are mostly within or near the range consistent with the Taylor principle, allowing for uncertainty about neutral rates, monetary transmission, and the size of the output gap. In many cases (for example, euro area and the

[6] Among the explanations for the growing gap are differences in the speed of diffusion of information and communication technologies. See, for example, Schnabel (2024).

[7] The data presented in Figure 13, panel 2, corresponds to GDP at purchasing power parity per capita. In the case of Ireland, as of 2022 modified gross national income at current market prices was about half of GDP. Modified gross national income measures the size of the Irish economy excluding globalization effects (see Central Statistics Office n.d.).

[8] Against the backdrop of the war in Ukraine, potential growth prospects have weakened particularly sharply in Russia (see Box 6).

Figure 13. Medium-Term Growth Projections



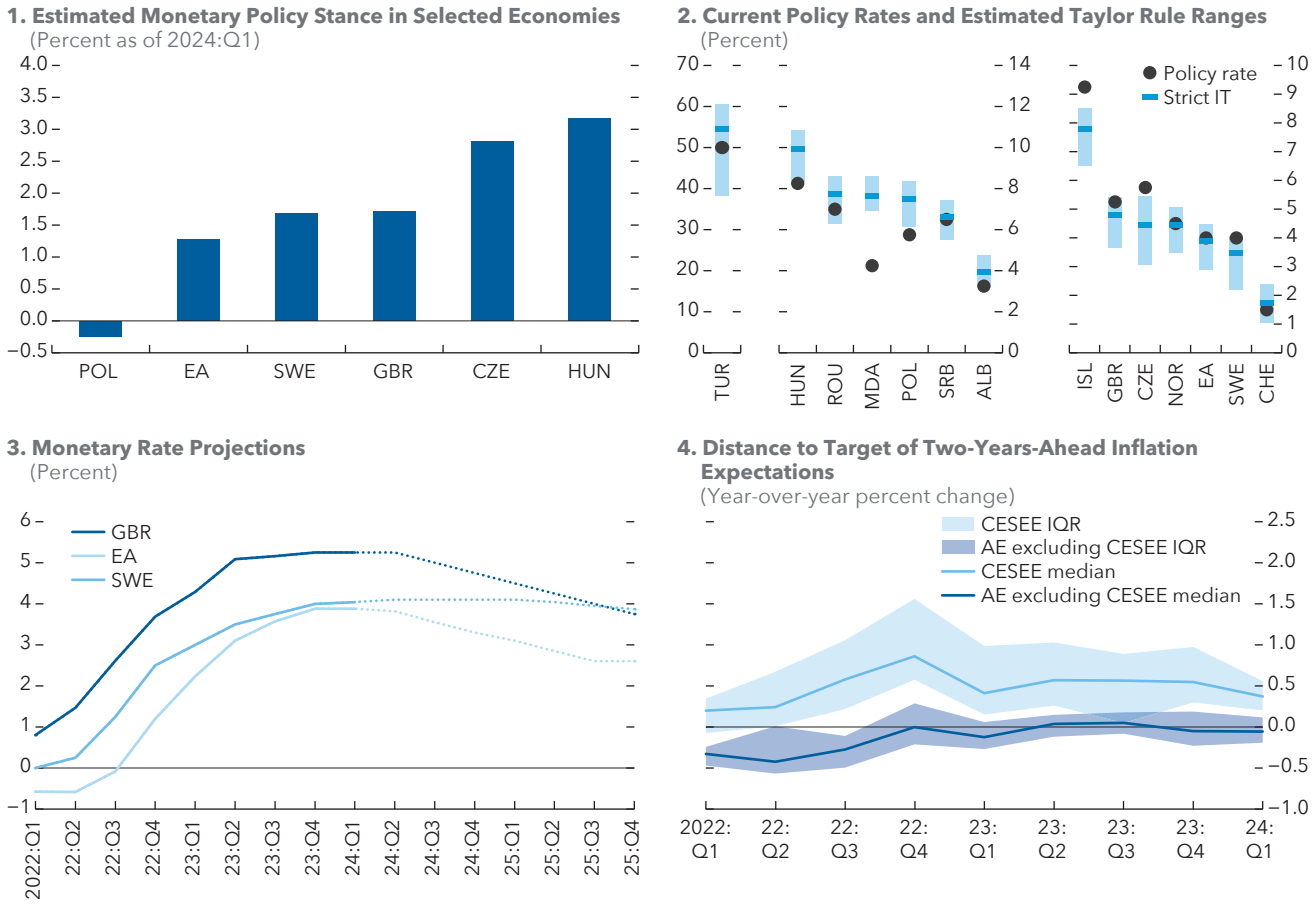
Sources: IMF, World Economic Outlook database; Long-Term Productivity Database; Penn World Table version 10.01; and IMF staff calculations.
Note: For panel 4, more details on the decomposition are in Box 1.1 of the October 2023 *World Economic Outlook*. CE includes Hungary and Poland. SEE EU includes Bulgaria and Romania. SEE non-EU includes Bosnia and Herzegovina and Serbia. Baltics include Estonia, Latvia, and Lithuania. CESEE includes Bulgaria, Bosnia and Herzegovina, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Moldova, Poland, Romania, Serbia, Slovak Republic, and Slovenia. Country abbreviations are International Organization for Standardization (ISO) country codes. AE = advanced Europe; CE = Central Europe; CESEE = Central, Eastern, and Southeastern Europe; EA = euro area; EA4 = France, Germany, Italy, Spain; EU = European Union; LFP = labor force participation; SEE = Southeastern Europe; PPP = purchasing power parity; TFP = total factor productivity.

United Kingdom), the easing cycle is expected to start in mid- to late 2024 and proceed through the end of 2025 (Figure 14, panel 3), bringing the ex ante real policy rate close to neutral levels toward the end of 2025 to early 2026.

The pace of monetary policy easing should match the evolution of underlying inflationary forces. Inflation is falling in most of Europe, but some of the factors that drive inflation in the absence of supply shocks are easing at different speeds: core services inflation and wage growth reached higher peaks and remain significantly stronger in CESEE (for example, Bulgaria, Croatia, Poland, and Romania). Inflation expectations one to two years ahead are at or close to target in advanced European economies outside of the CESEE region, but persistently above it in CESEE (Figure 14, panel 4).

In advanced European economies, a gradual pace of easing is desirable under the baseline. Monetary policy must be carefully calibrated to avoid loosening too fast or maintaining a tight stance too long. In the euro area and other advanced economies in Europe, activity and core inflation have fallen faster than anticipated, but labor markets remain tight and negotiated wage growth is still vigorous. Policy decisions should continue to be

Figure 14. Monetary Policy



Sources: Central bank statistics; Consensus Economics; Haver Analytics; IMF, World Economic Outlook database;Riksbank; and IMF staff calculations.
Note: In panel 1, the monetary policy stance is the distance between the ex ante real policy rate (based on one-year-ahead inflation expectations) and the estimated neutral (short-term) real rate for each country. It is positive where the stance is assessed as tight, and negative where it is assessed as loose. Panel 2 compares the current nominal policy rate to an estimated range of rates consistent with a Taylor-type rule, allowing for uncertainty about the neutral rate of interest, and different central bank reaction functions (April 2023 *Regional Economic Outlook: Europe*). For illustrative purposes, the "Strict IT" lines indicate a Taylor rule rate for the hypothetical case where the central bank responds to inflation deviations from target, but not to changes in the output gap. This rule does not necessarily reflect the optimal simple policy rule or central bank mandates. The Central Bank of the Republic of Türkiye uses various quantitative and macroprudential rules as part of its monetary policy regime that are not taken into account here. In panel 3, the projected policy rates for Sweden correspond to the Riksbank's interest rate path as in the November 2023 monetary policy report. In panel 4, AE excludes CESEE and includes Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Ireland, Israel, Italy, The Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. CESEE includes Albania, Belarus, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Moldova, Poland, Romania, Serbia, Slovak Republic, and Slovenia. Country abbreviations are International Organization for Standardization (ISO) country codes. AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe; EA = euro area; IQR = interquartile range; IT = inflation targeting.

data dependent, with a meeting-by-meeting approach that adjusts the path should downside or upside risks to growth or inflation materialize. The Eurosystem and the Bank of England should continue to reduce their bond holdings and shrink their footprint in financial markets, gradually and predictably.

Many CESEE economies need a tight monetary stance for longer to fully rein in inflation. Such a stance is warranted where wage growth remains strong, core inflation sticky, and inflation expectations above target; this may, in some cases, be consistent with careful reductions in nominal policy rates, depending on the evolution of short-term expectations (Figure 14, panel 4). Given the high cost of erring on the side of too-loose monetary policy when inflation persistence remains high, policymakers need to be cautious about premature loosening (Brandao-Marques, Meeks, and Nguyen 2024). A tightening bias—reacting more strongly to higher-than-expected inflation

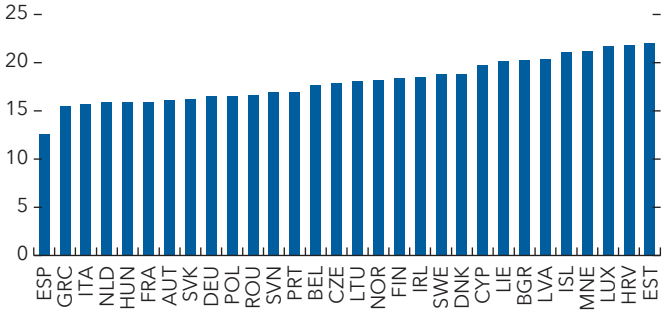
than to good (downside) surprises—helps prevent inflation from becoming embedded in expectations, leading to pricing decisions that keep inflation high, which would require further tightening, causing a sharper economic downturn later. In many of these economies, exchange rate pass-through to inflation—normally also faster than the domestic demand channel—strengthens the case for caution. In the specific case of Türkiye, where inflation is expected to start declining only toward the middle of the year, the central bank's tightening bias is appropriate and should be maintained as long as expectations and inflation remain high.

Financial Sector Policies: Maintain Stability Without Hampering the Recovery

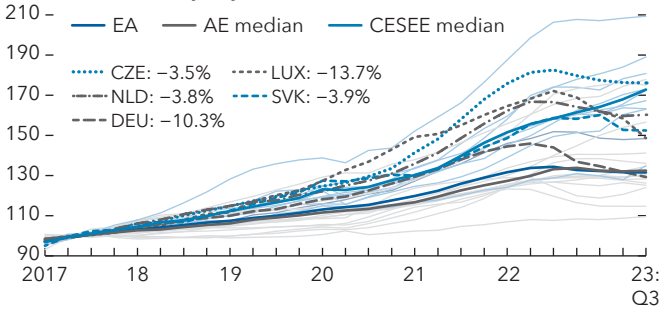
Macroprudential policies should ensure that banks are robust to larger-than-expected increases in NPLs. While NPLs through the third quarter of 2023 have in aggregate remained mostly flat in both the euro area and the CESEE region, they have risen in certain segments, like commercial real estate (see the November 2023 *Regional Economic Outlook: Europe*). This may increase further due to property sector stress (for example, in Germany and Luxembourg, where nominal house prices have fallen significantly) and rising corporate bankruptcies (Figure 15). In CESEE, despite recent improvements in credit quality, banks continue to expect an overall increase in NPLs in the near term, across retail and firms, due to weak economic growth and high interest rates (IMF 2023a; EIB 2023). Prudence in profit distribution should be encouraged. This would lock in temporarily high bank profits into capital, helping to preserve adequate buffers without pushing banks to either issue new equity or cut lending. Where appropriate—for example, where credit is not already constrained by the adequacy of banks' capital—this objective can be achieved by raising countercyclical capital

Figure 15. Financial Sector Policy

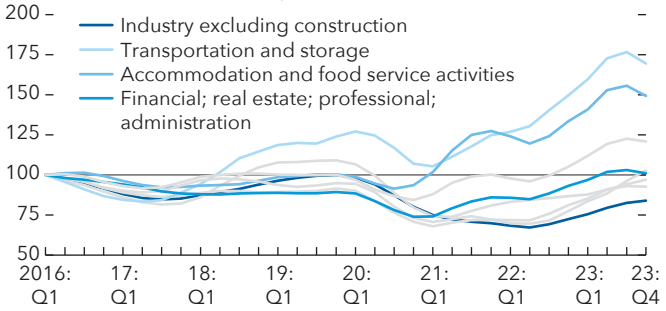
1. Bank Capital Buffers, 2023:Q4
(Ratio)



2. Nominal House Prices in Europe
(Index, seasonally adjusted, 2017 = 100)



3. EU27: Rising Corporate Bankruptcies
(Index, 2016 = 100; four-quarter moving averages)



Sources: European banking authorities; Eurostat; Haver Analytics; Organisation for Economic Co-operation and Development; and IMF staff calculations.
Note: Panel 1 shows the ratio of common equity Tier 1 to risk-weighted assets. For panel 2, dashed lines represent countries that experienced the largest decreases in their price index from 2022:Q3 to 2023:Q3, with each country's numerical representing year-over-year percent change. AE excludes CESEE and includes Austria, Belgium, Denmark, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Luxembourg, The Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. CESEE includes Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Russia, Slovak Republic, Slovenia, and Türkiye. In panel 3, EU27 includes Austria, Belgium, Bulgaria, Croatia, Republic of Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and Sweden. Country abbreviations are International Organization for Standardization (ISO) country codes. AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe; EA = euro area.

buffers, standing ready to release them if stresses, such as increased defaults, were to materialize in the future (October 2023 *Global Financial Stability Report*). Ad hoc discretionary taxes on realized bank profits should be avoided.

Supervisors should continue to monitor the credit quality of banks' substantial commercial real estate portfolios carefully, and where appropriate deploy targeted measures to mitigate stress from this segment (see the November 2023 *Regional Economic Outlook: Europe*). Where pockets of vulnerabilities warrant targeted tightening, care should be taken to minimize migration of risks to nonbank financial institutions (NBFIs).

The ability to mitigate risks from NBFIs should be strengthened. Growth in Europe's NBFI sector has exceeded growth in the banking sector after the global financial crisis. The sectors are interconnected through funding dependencies—with NBFIs the source of around half of repo funding to euro area banks (ECB 2023a, 2023b)—and securities and derivative exposures. Inadequate preparedness to meet margin and collateral calls—on interest-rate derivative positions of UK pension funds in 2022 and on EU insurance corporations and pension funds in 2020—triggered adverse feedback loops (fire sales, pushing prices further down, accelerating margin calls), causing market-wide stress. These experiences underscore the vital roles of robust surveillance, regulation, and supervision as first lines of defense. Priorities should be to close key data gaps, incentivize risk management by NBFIs, set appropriate regulation, and intensify supervision. Central bank liquidity support should be subject to guardrails (see Chapter 2 in the April 2023 *Global Financial Stability Report*).

Fiscal Policy: Time to Strengthen Sustainability

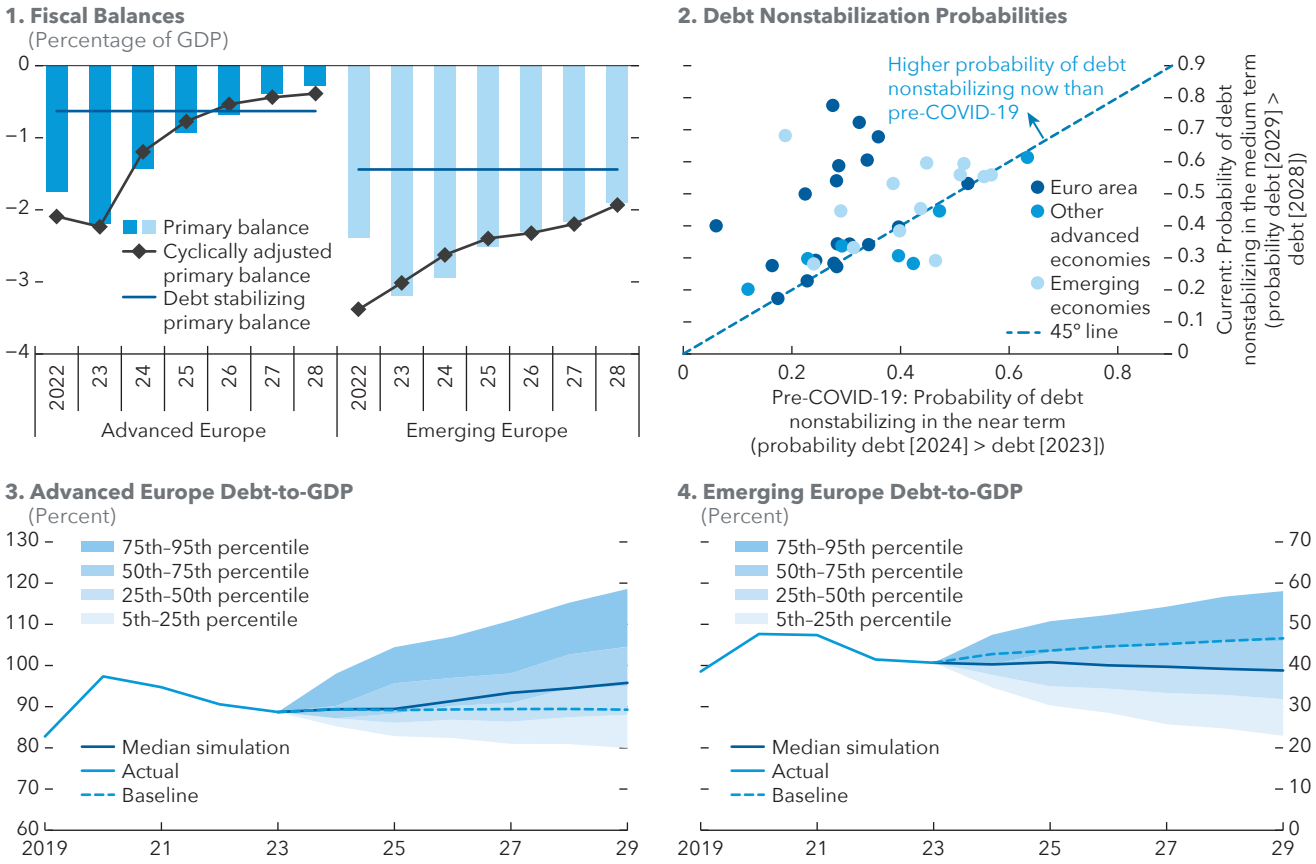
Fiscal consolidation is expected to expand across Europe in 2024, albeit more slowly in CESEE (Figure 16, panel 1). In general, advanced European economies are consolidating faster, but the probability that debt will not stabilize is projected to increase in the medium term in many countries (Figure 16, panel 2). Insufficient primary balance adjustment and lower-than-expected growth remain the key risks to debt stabilization. Debt fanchart analyses point to high adverse risks for advanced economies and a wide dispersion of risks among emerging market economies (Figure 16, panels 3 and 4). High public debt and financing needs, combined with some of the highest bond market yields in about a decade, are adding to governments' financing costs.

With unemployment expected to remain low and growth rebounding, it is a good time to rebuild the buffers needed for the next crisis. Europe's fiscal responses to the COVID-19 pandemic and 2022 energy crisis (unleashed by Russia's invasion of Ukraine) were bold and swift. They not only stabilized demand but also continued to protect the vulnerable (Figure 17). Inevitably, however, the magnitude of the support needed made public debt stocks jump.

Some of the economic effects of these crises can be long lasting, but as their temporary components fade and private demand rises, the rationale for temporary support has waned. Consolidation will strengthen sustainability, help rebuild buffers against downside risks that would activate automatic stabilizers, and make room for spending pressures from aging, climate, and defense. It will also help mitigate risks to medium-term growth from crowding out of private investment, and—for most in the CESEE region—avoid further erosions to competitiveness. Moreover, consolidation will aid monetary policy efforts toward price stability. The adjustment should be pursued in a way that does not undermine necessary public investment, and with social protection systems continuing to protect the vulnerable (Figure 17).

To balance output and debt stabilization, European economies generally need more significant and less backloaded fiscal adjustment than currently planned to ensure debt remains sustainable while minimizing the impact of fiscal consolidation on output. The broad scope of the required adjustment can be illustrated with the help of a simple model of optimal fiscal policy (Fournier 2019), which weighs the benefits of output stabilization against the costs of debt unsustainability. Figure 18 shows a representative European advanced economy and a representative European emerging market economy. At the end of 2023, the representative advanced

Figure 16. Fiscal Policy

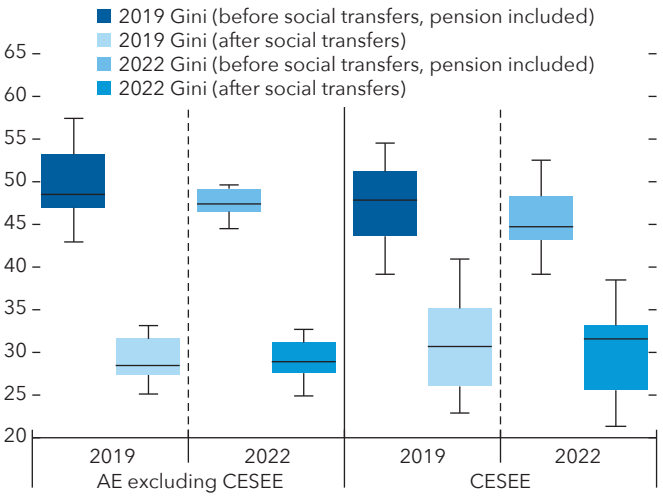


Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: Panel 1 shows aggregate using purchasing power parity weights. Debt stabilizing primary balance calculated using 2026 projections. Emerging Europe excludes Belarus, Moldova, Montenegro, Russia, Türkiye, and Ukraine. In panel 2, the probability is calculated by the share of simulated stochastic debt trajectories that result in nonstabilizing debt ratios as in IMF (2022). Advanced Europe and emerging Europe exclude Andorra, Belarus, Kosovo, Russia, and Ukraine. Panel 3 excludes Andorra and Norway, and panel 4 excludes Belarus, Kosovo, Russia, and Ukraine.

economy had a positive output gap of 0.2 percent, closing in the medium term, and public debt of 67 percent of GDP. The representative emerging market economy, in turn, had a negative output gap of 0.2 percent and public debt of 44 percent of GDP. While both need to consolidate more, the model suggests higher adjustment relative to the baseline is needed in the representative emerging market economy (about 1.5 percentage points by 2029) than in the advanced economy (about 1 percentage point). This mainly reflects a higher cost of financing and differences in the baseline fiscal paths. Notably, the baseline medium-term debt path in the representative emerging market economy is steeper, suggesting higher debt sustainability risks that warrant faster consolidation. In both cases, growth-enhancing reforms

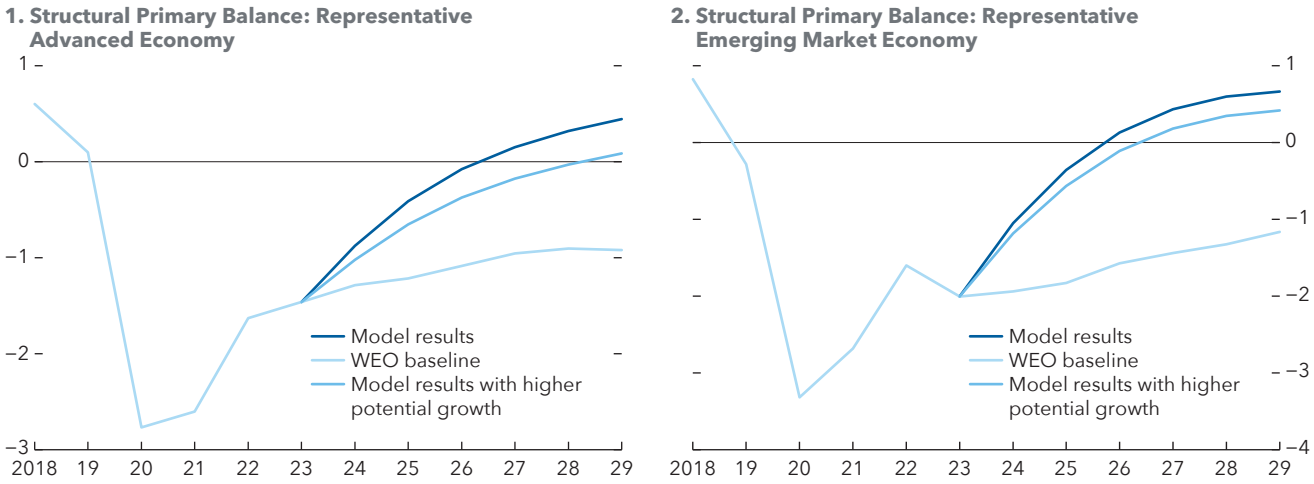
Figure 17. Gini Index

(Index)



Sources: Organisation for Economic Co-operation and Development; and IMF staff calculations.
Note: AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe.

Figure 18. Higher Fiscal Adjustment Needs Suggested by an Optimization Model
(General government, percent of potential GDP)



Source: IMF staff based on Fournier (2019).
Note: WEO = *World Economic Outlook*.

would ease the necessary pace of consolidation. For example, reforms that raise GDP levels by about 4 percent cumulatively through 2029 would lower the average annual adjustment by about 0.3 percentage point in the representative advanced economy and 0.2 percentage point in the representative emerging market economy in 2024–29.[9]

Advanced European economies with relatively high debt levels should implement more significant and front-loaded fiscal consolidation than envisaged under the authorities' current policies (for example, Belgium, France, and Italy). Recommended policy measures include raising the efficiency of spending, implementing revenue-enhancing tax reforms, and cutting tax expenditures. Growth-enhancing reforms will be especially critical in these high-debt countries. In advanced economies with relatively low debt levels, staff recommend less consolidation than planned by the authorities; this would allow more support for growth-enhancing green public investment (for example, Germany and, to an extent, Sweden).

In most of CESEE, the recommendation is for more front-loaded consolidation, while meeting the region's elevated needs for investment in infrastructure and labor skills (for example, Bulgaria), and the energy transition (for example, Poland). Helpful policies include realizing expenditure efficiency gains and raising revenue—for example, broadening the tax base, eliminating exemptions, and in some cases (for example, Romania) also streamlining value-added taxes and personal income taxes. Across the region, energy crisis support measures—still significant in in several economies (for example, Bosnia and Herzegovina, Croatia, Hungary, Malta, and Slovakia)—should be fully withdrawn (Figure 19).

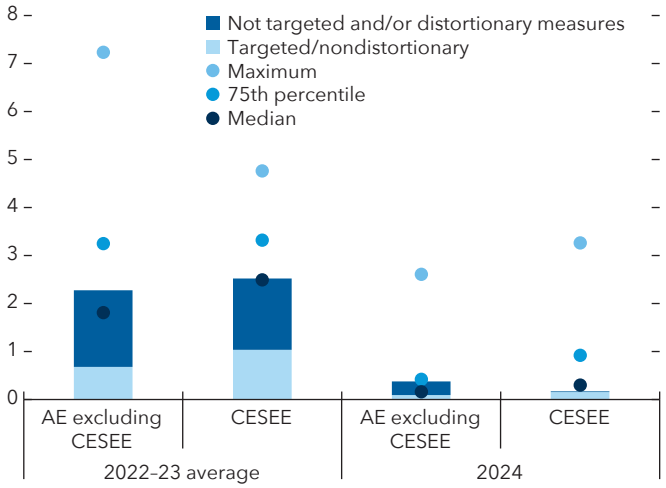
Deeper fiscal reforms will be needed to address expenditure pressures associated with aging, defense needs, and financing the green transition. Structural reforms to lift per capita growth should be part of the solution, but fiscal measures will be needed as well, because many of these pressures increase with aggregate income levels (see Box 2). Absent a sustainable fiscal response, the risk is that some spending needs will be left unmet or otherwise met with increasingly growth-unfriendly measures, such as higher debt that crowds out private activity by pushing up financing costs. While some countries, especially in the CESEE region, have room to increase tax revenues, in many economies reforms to shift obligations to the private sector (for example, through

[9] The assumption of reforms raising GDP levels by about 4 percent through 2029 is consistent with phasing in gradually the result in Baba and others (2023) showing long-term real income gains of 7 percent from reducing internal EU barriers by 10 percent (see Structural Policies section for further details).

carbon taxes or strengthening supplementary private pension plans) and improve spending efficiency will have to play a role.

For EU countries, the reformed economic governance framework can help to strengthen long-term fiscal sustainability. In the new fiscal framework for EU member states, country-specific adjustment requirements are set on the basis of a long-term debt sustainability analysis, taking into account aging-related spending pressures (see Box 1), with some minimum adjustment requirements. If implemented well, the fiscal adjustment will—with a high likelihood—put debt on a sustainable trajectory, while also building up room for countercyclical fiscal policy. To enhance country ownership of the new fiscal rules—and also facilitate compliance monitoring—the adjustment paths for net primary expenditure are set in medium-term fiscal-structural plans, proposed by member states and approved by the European Commission and the Council. Countries that undertake structural reforms or public investments that increase potential growth, strengthen macroeconomic resilience, or improve fiscal sustainability are granted longer adjustment periods. The new framework also contains enhanced requirements on medium-term budget framework and independent fiscal institutions, which can support the implementation of medium-term adjustment.

Figure 19. Energy Crisis Support Measures
(Percent of GDP)



Source: IMF staff calculations.
Note: Targeted/nondistortionary measures represent support measures in government spending for households that do not have impact on energy prices. AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe.

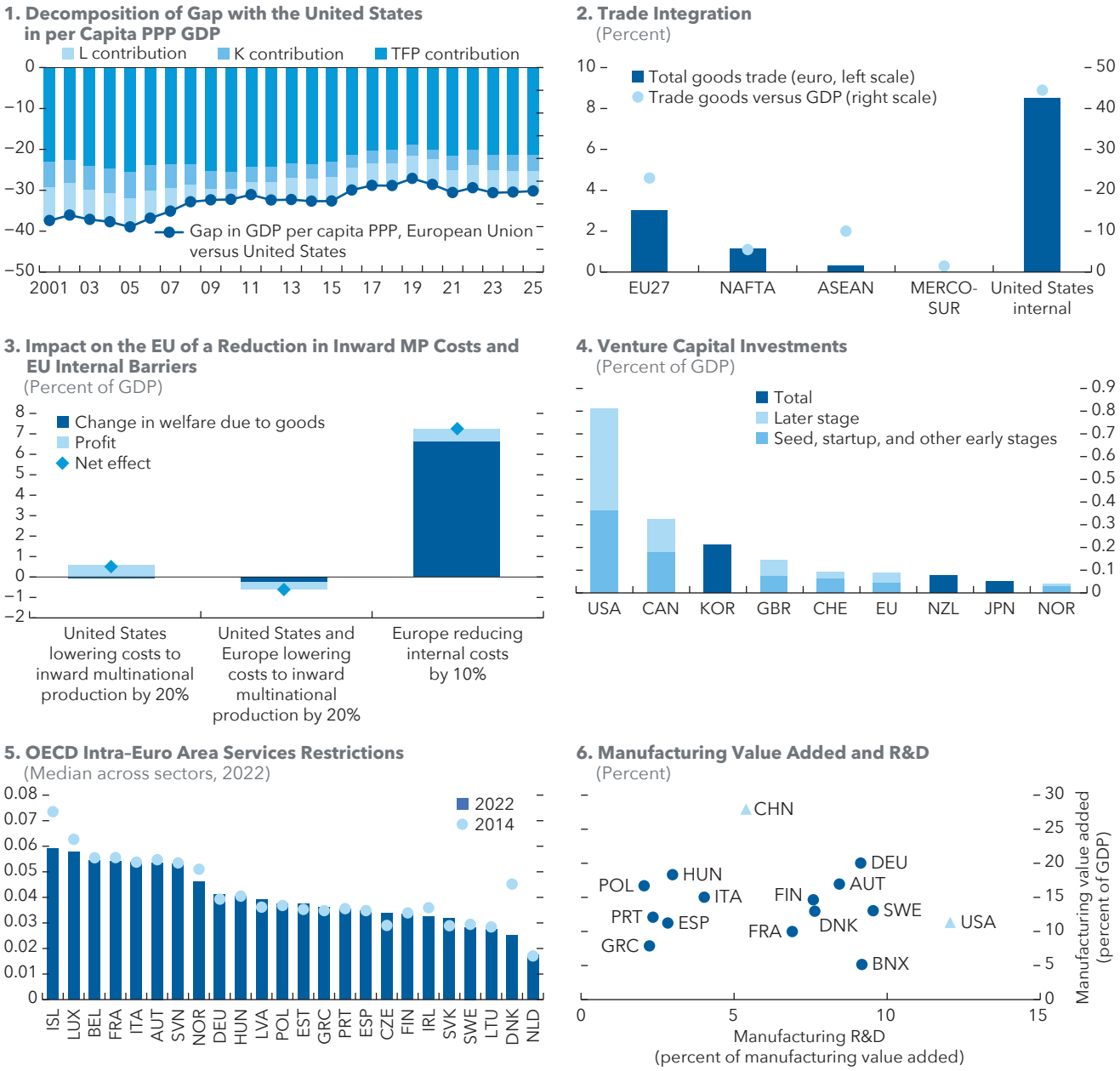
Structural Policies: Building on the Single-Market Strengths

To lift its medium-term growth prospects, Europe must raise productivity. Differences in per capita income levels with the United States are driven by labor, capital, and productivity shortfalls—but the contribution from the latter stands out (Figure 20, panel 1). The capital stock of the European Union is estimated to be 88 percent of that in the United States, and the labor input of the European Union is 92 percent of that in the United States. While these are significant differences, total factor productivity in the European Union is only 78 percent of that in the United States. Interpreted through the lens of standard growth accounting, the differences in total factor productivity between the European Union and the United States explain about 70 percent of the total per capita gap between the two economies.

There are large untapped productivity gains from further deepening of the European Union's single market. While EU integration among otherwise independent countries is exemplary, a number of recent studies have quantified remaining barriers constraining the single market.

Barriers to factor movement appear to remain especially high, and with large potential benefits from removing them. For example, Gorodnichenko and others (2021) estimate that the better allocation of resources from removing obstacles to investment would lead to productivity gains of 13.5 percent. Head and Mayer (2021) find that frictions that prevent labor mobility within the European Union remain very large. Workers' costs of migrating between EU countries (which can reflect, for example, the lack of portability of pensions or professional licensing requirements) is about eight times higher than for migration between US states.

Figure 20. Gap with the Frontier and Untapped European Potential



Sources: European Commission; OECD; World Bank, World Development Indicators; and IMF staff calculations.
Note: In panel 6, based on *K*-means clustering to minimize sum of within-cluster distances, three clusters were generated. BNX represents Belgium, The Netherlands, and Luxembourg. EU27 includes Austria, Belgium, Bulgaria, Croatia, Republic of Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and Sweden. Country abbreviations are International Organization for Standardization (ISO) country codes. ASEAN = Association of Southeast Asian Nations; MERCOSUR = Southern Common Market; MP = multinational production; NAFTA = North American Free Trade Agreement; OECD = Organisation for Economic Co-operation and Development; PPP = purchasing power parity; R&D = research and development; TFP = total factor productivity.

And there are still notable untapped productivity gains from trade. Trade integration in the European Union is higher than in other regional agreements, but only a fraction of the level observed among states in the United States (Figure 20, panel 2). While some of this reflects permanent country characteristics such as language, there is evidence that policies can raise integration further for the benefit of all in Europe. For example, Felbermayr and Tarasov (2022) document the underinvestment in border infrastructure in Europe and find real income gains

of about 1.6 percent from moving to first-best border infrastructure. Using a trade model, Spornberger (2020) reports untapped liberalization potential in the single market that could yield 2.3 to 3.6 percent increases in real incomes. Based on simulations that also account for the effects of integration on innovation, Baba and others (2023) show long-term real income gains of 7 percent should the European Union reduce its internal barriers by only 10 percent (see Figure 20, panel 3, rightmost bar).[10]

Some recent EU proposals constitute steps in the right direction, but further efforts are needed. Progress on developing the European Single Access Point, an online repository for corporate financial information, and the European Commission's 2023 proposal to harmonize elements of members' insolvency procedures are welcome, but there is need for faster progress and more ambition. A key area is promoting further cross-border risk sharing and expanding the currently limited role of risk capital to finance innovation and growth (Figure 20, panel 4). Helpful policy measures include creating portable pension products, streamlining cross-border withholding taxes—all of which will make it easier for households to invest in capital markets—fostering supervisory convergence, and centralizing oversight of systemic financial market infrastructures (Bhatia and others 2019). The Commission should build on the Eurogroup's March 2024 statement on the future of the Capital Markets Union and aim for comprehensive reforms that can substantially improve the financing landscape of European firms. On services trade, the recent initiative to facilitate cross-border operations for telecommunications companies could help lower barriers. Data suggest, however, that there is scope for further services trade liberalization more broadly—with relatively little progress seen in recent years (Figure 20, panel 5). All these reforms will require political resolve to overcome vested interests, give up control of segmented markets, and deal with adjustment costs.

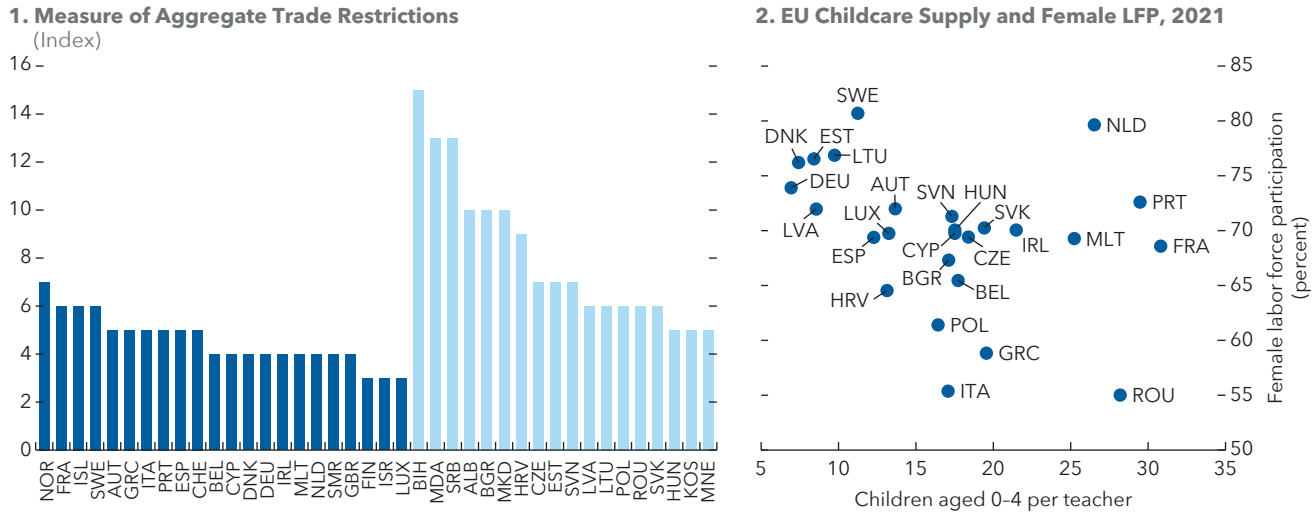
A deeper single market is also the right response to fragmentation pressures. There are legitimate economic security concerns around the overreliance of supply from other countries or economic specialization. For instance, Europe is a net importer of energy, and its energy security had been gradually deteriorating up to Russia's invasion of Ukraine, due to increased energy import dependence and rising concentration of energy supplies. Yet subsidies deployed at the national level similar to current US policies under the Inflation Reduction Act would undermine the single market and, by leading to a less efficient allocation of resources, on net lower real incomes by about 0.6 percent (Figure 20, panel 3, middle bar). Instead, Europe should build on the single-market strengths. Given its uniquely heterogeneous country composition, spanning innovation and manufacturing centers (Figure 20, panel 6), regional integration can also enhance resilience to downside fragmentation risks (Baba and others 2023; Gopinath 2023).

Electricity market integration would also help ease some of the pressures stemming from the energy transition (Dolphin and others, forthcoming).

Efforts at the regional level should be boosted by complementary domestic reforms to address old and new challenges. Clear communication, including on the benefits of reforms and how to address adjustment costs where appropriate, and a firming-up of the recovery can both help build political support. Reform priorities, however, need to respond to country circumstances.

[10] The trade models used in Spornberger (2020) and Baba and others (2023) assume that factors of production are immobile across borders, making the gains cited orthogonal to those that would stem from further factor-market integration. In some cases, trade and factor integration policies can complement each other (for the case of the 2004 EU enlargement, see, for example, Caliendo and others 2021).

Figure 21. Scope for Further Domestic Structural Reforms



Sources: Estefania-Flores and others (2022); Eurostat; and IMF staff calculations.
Note: Panel 2 uses 2021 or latest available data. Country abbreviations are International Organization for Standardization (ISO) country codes. LFP = labor force participation.

In the CESEE region:

- *Raising investment and improving capital allocation*. Capital stocks in CESEE are substantially below the levels observed elsewhere in Europe. And, while nearshoring might make some economies more attractive foreign direct investment destinations, the degree to which each country benefits will depend on domestic policy conditions. In many economies, there is scope for developing a domestic investor base (for example, voluntary pension schemes), improving governance and stepping up anticorruption efforts, and strengthening bankruptcy frameworks. Lowering trade barriers, which are higher than the European average (Figure 21, panel 1), would also incentivize foreign direct investment. NextGenerationEU-funded projects have the potential to significantly raise income levels in Europe. Maximizing implementation of projects funded by the EU funds is therefore critical, and many in the CESEE region are lagging (see Box 3). Raising investment needed for the green transition will, however, require additional efforts, such as improving the regulatory climate for attracting private capital in the energy sector (for example, Poland) and tightening energy-efficiency regulations (Czech Republic). Carbon taxation and excise taxes also play a role in improving capital allocation for the green transition.
- *Increasing labor supply and skills*. For those economies seeing an upturn in immigration, there is scope for building on the recent successes (for example, in Poland) to further improve the integration of immigrants into the labor force (such as through additional training and skill development). Some economies in CESEE facing particular emigration pressures should seek to improve the quality and completion rates of tertiary education (for example, North Macedonia) and improve the business environment. Increasing childcare supply can help boost female labor force participation (for example, in Romania, but also in many other countries; Figure 21, panel 2), and pension reforms can ease aging pressures (see Box 2). Active labor market policies (for example, through reskilling and vocational training) can build on some recent efforts to identify labor mismatches and help bolster preparedness to the advent of new technologies (see Box 4).

Among advanced economies:

- *Raising investment and improving capital allocation*. Meaningful progress in the European Union on the banking and capital markets unions would not only enhance cross-border risk sharing, but also deepen access to finance for households and firms. Stronger insolvency frameworks that shorten the time to resolve

proceedings (for example, Greece and Portugal) would expand firms' access to credit, help banks resolve NPLs, promote entrepreneurship, and deepen debt markets. There is also scope for promoting firm entry (for example, by easing regulatory barriers [Germany] and streamlining approval requirements [United Kingdom]).

- *Increasing labor supply and improving its allocation*. Aging economies will benefit from reforms that keep older workers in the labor force for longer and reduce disincentives to work. Depending on country circumstances, there is still significant scope for raising female labor force participation[11] (for example, Italy and Spain) and extending their working hours (for example, Austria and Germany). Immigration remains an important channel through which countries can raise labor supply, particularly if immigrants are quickly integrated. Skill shortages and mismatches require urgent efforts, including by fine-tuning immigration (United Kingdom) and ensuring smooth transition of apprentices into permanent work and addressing performance gaps and inefficiencies in education (France).

Promoting innovation will be critical to raise productivity. Several of the aforementioned reforms can help promote innovation (for example, improving education and increasing the role of venture capital). For countries already close to or at the technology frontier, a well-designed pro-innovation fiscal policy mix entails a combination of research and development tax incentives, research and development grants for startups (especially in high social return sectors like green technologies), and public investment for basic research alongside strengthened university-business linkages. Careful design of fiscal incentives is, however, imperative to minimize fiscal costs, avoid cementing market power, and prevent misallocation. Countries behind the frontier should focus on facilitating adoption of existing technologies, including, for example, greater investment in digital infrastructure.[12] Innovation for the green transition should rely heavily on the incentives that stem from carbon pricing, which provides market participants with price signals that fully reflect externalities.

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[11] More generally, it is estimated that policies that close the gap between actual and desired hours of work can increase labor supply by 1.3 percent (Astinova and others 2024).

[12] See Chapter 2 in the April 2024 *Fiscal Monitor* for further details.

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Box 1. Reformed European Economic Governance Framework

In February 2024 the Council and Parliament approved a reformed economic governance framework for EU members. The new framework aims at promoting sustainable public finances while at the same time encouraging growth-supporting reforms and investments. Countries that are considered to face long-term risks to their public finances are required to submit adjustment plans that have a high likelihood of restoring fiscal sustainability. The fiscal adjustment should be gradual and realistic, while also allowing countercyclical policy. In line with this, member states with deficits or debt levels exceeding the framework's reference values—currently 17 of the 27 EU member states—are asked to agree with the Commission and the Council a four- or seven-year fiscal-structural plan, relying on net primary expenditure[1] as the single operational indicator. The implementation of this plan will be monitored through annual progress reports, allowing the Commission to verify compliance with the net expenditure path.

The framework distinguishes two phases: an adjustment period and a 10-year debt trajectory phase, over which long-term fiscal sustainability is assessed. The baseline adjustment period is four years. However, countries committing to structural reforms and public investments that enhance economic resilience or potential growth—or strengthen fiscal sustainability—can be allowed to extend the adjustment period to seven years, thereby reducing the pace of annual fiscal adjustment. Restoring and entrenching fiscal sustainability—the primary objective of the framework—is specified along two dimensions. Public debt should be plausibly placed on a downward path, or, if already low, maintained at prudent levels. This is referred to as the debt criterion. Fiscal deficits should, if high, be reduced and subsequently be kept moderate. This is referred to as the deficit benchmark.

The debt criterion is assessed on the basis of a debt-sustainability analysis covering the 10-year debt trajectory phase during which—for the sake of the analysis—the primary fiscal balance is assumed to be constant, with the exception that costs related to an aging population are added. The debt-sustainability analysis—which is done according to an established methodology—examines the evolution of debt under various prespecified scenarios and shocks, such as lower GDP growth or higher fiscal deficits. In the debt-sustainability analysis, if debt is above 60 percent of GDP it should decline with a high probability. If below 60 percent of GDP, it should not exceed this threshold. The deficit benchmark requires that by the end of the adjustment period, the general government deficit is below 3 percent of GDP and is projected to remain below this level for the entire 10-year debt trajectory phase.

In addition to the debt criterion and the deficit benchmark, the framework includes two minimum adjustment safeguards. According to a debt sustainability safeguard, over the adjustment period the debt-to-GDP ratio should fall on average by no less than 1 percentage point of GDP annually if debt is above 90 percent of GDP and 0.5 percentage point of GDP annually if debt is between 60 and 90 percent of GDP. According to the deficit resilience safeguard, if the general government structural balance is less than –1.5 percent of GDP, the annual improvement of the structural primary balance should not be less than 0.4 percentage point of GDP for countries with a four-year adjustment period, and 0.25 percentage point for those with a seven-year adjustment period.

Member states that violate the fiscal requirements under the framework—either by having a general government deficit that exceeds 3 percent of GDP or by failing to implement the agreed net expenditure path—can be placed in an Excessive Deficit Procedure. Unless the adjustments agreed in the medium-term

This box was prepared by Gösta Ljungman.

[1] Defined as general government expenditure, net of interest expenditure, discretionary revenue measures, expenditure on EU programs fully matched by EU funds revenue, national expenditure on co-financing of programs funded by the European Union, cyclical elements of unemployment benefits, and one-offs and other temporary measures.

Box 1. ***(continued)***

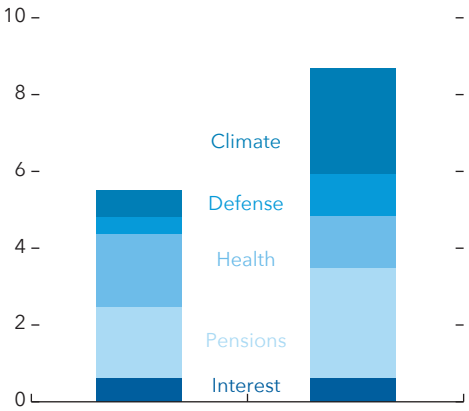
fiscal structural plan is higher, while in an Excessive Deficit Procedure, the country is required to make a minimum annual improvement of the structural fiscal balance of 0.5 percent of GDP to bring it back to compliance with the framework. Although the minimum adjustment is generally defined in terms of the structural balance, as a transition measure, during 2025–27 it can be adjusted to take into account higher interest expenses. During the time a country is in the Excessive Deficit Procedure, it is excluded from the annual debt-reduction requirement under the debt sustainability safeguard.

The reform also includes requirements on member states' budgetary frameworks—including medium-term fiscal planning—analysis of macro-fiscal risks, and country-specific numerical fiscal rules. Member states are also required to ensure the existence of independent fiscal institutions with sufficient competence, autonomy, and resources. These institutions should—at a minimum—be tasked with macroeconomic forecasting, fiscal rules monitoring, and evaluation of budgetary frameworks. Member states are required to comply with the recommendations of the assessments of the independent fiscal institutions or provide a public explanation of why they do not.

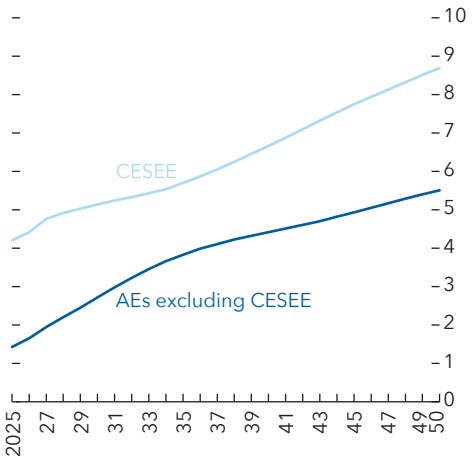
Box 2. Expenditure Pressures

On top of near-term needs to reduce structural fiscal deficits in line with the new EU fiscal rules (see Box Figure 2.1) and/or to ensure fiscal sustainability, European countries are facing medium- to long-term spending pressures. Demographic trends and aging populations are adding to pension and health care costs, large investments are required to reach climate goals, and many countries have committed to increasing defense spending. These spending pressures are substantial and expected to increase further over the long term. In advanced European economies, they are estimated at around 5½ percent of GDP annually by 2050, while in Central, Eastern, and Southeastern Europe economies, they are around 8½ percent (Box Figures 2.1 and 2.2). Europe's emerging markets are most heavily affected, as their populations are aging faster than in most advanced economies, driving up pensions. Also, the costs of climate transition could be higher as a share of GDP than in advanced economies because of generally greater reliance on fossil fuels at present.[1]

Box Figure 2.1. Europe: Additional Annual Spending Pressures by 2050
(Percent of GDP)



Box Figure 2.2. Europe: Additional Annual Spending Pressures, 2025–50
(Percent of GDP)



Sources: European Commision; European Investment Bank; IMF, World Economic Outlook database; and IMF staff estimates and projections.
Note: Annual spending pressure beyond baseline. Baseline: defense spending at 2021/22 levels, health and pensions at 2023 levels, interest at constant interest rate. Climate transition at 2011–20 levels. Weighted by GDP. Excludes Andorra, Belarus, Israel, Kosovo, Russia, San Marino, Türkiye, and Ukraine.
AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe.

Given their scale, meeting these spending pressures will be challenging. Higher economic growth cannot be the only solution, as some pressures are endogenous (for example, higher-income societies demand higher-quality health care, pensioners want to keep relative income levels, and defense spending targets

This box was prepared by Oyun Adilbish, Nina Budina, Irina Bunda, Stephanie Eble, Gee Hee Hong, Sabiha Mohona, Alla Myrvoda, Alex Pitt, Keyra Primus, and Moheb Thabet.

[1] These estimates are broadly consistent with those presented in the April 2024 *Fiscal Monitor,* with differences explained by country coverage and policy assumptions. Estimates for the costs of the climate transition are highly uncertain. Further spending demands arise from the need to close infrastructure gaps in emerging Europe and to replace aging infrastructure in advanced Europe, which are not quantified here.

Box 2. *(continued)*

are set as a share of GDP). Also, the cost of some services (for example, long-term care) is expected to increase with rising income levels. Fiscal consolidation to achieve sustainable finances will already to some extent constrain the scope for expenditure reprioritization and/or require revenue measures.

This makes the need for deeper structural fiscal reforms even more pressing, including as they take time to yield results. A number of countries have, over the past decade, implemented reforms to mitigate future spending pressures.

- *Pension systems*. Main reforms to mitigate pension costs have included increasing the statutory retirement age and/or increasing minimum contribution years (for example, Bulgaria, France, Greece, Spain, and Sweden), indexing the retirement age to life expectancy (for example, Estonia, Greece, and Slovakia), reducing early retirement options (for example, Austria, Czech Republic, Romania, and Spain), and aligning the retirement age of women with the one of men (for example, Austria, Bulgaria, and Romania). However, such reforms are slow to have an impact and socially difficult to implement. In some countries (for example, Ireland and The Netherlands), earlier reforms were fully or partially reversed.
- *Health care reforms* are usually complex and have several aims. Digitalization, governance and procurement reform, and the introduction of co-payments are designed to reduce costs directly (for example, Croatia, Cyprus, and Italy), while other reforms seek to broaden access—which may save costs by providing less expensive primary care or reduce reliance on old age homes (France, Greece).
- *Green transition*. Higher taxes on pollution, especially carbon taxes (for example, Austria and Germany), alter incentives for the private sector and generate revenues. While a significant share of these revenues would need to be used to offset the impact of such taxes on lower-income households, they may also free funds for public investment.
- *Defense*. Common procurement and standardization of weapons systems offer the opportunity to save on large defense-related investments. However, North Atlantic Treaty Organization defense spending targets are set in numerical terms, and increased efficiency would be channeled into more and better equipment.

Moreover, establishing comprehensive frameworks to account for and plan to meet all spending pressures at the national level is urgently needed. Only a few European countries have taken the initiative to amalgamate *all* of the identified spending pressures into long-term fiscal and public debt projections and established an institutional framework to address them (Denmark, Finland, The Netherlands, Norway, Spain, Sweden), while only in a subset of these fiscal anchors are calibrated to incorporate long-term considerations. While the European Commission, with its regular reports on costs related to aging societies, is providing a common framework for EU member states, most non-EU countries currently do not have such projections. Spending related to the green transition is frequently not incorporated into medium-term fiscal frameworks, and few of the national plans to achieve EU targets on the climate transition are costed. Only six countries have comprehensive assessments of long-term fiscal impacts of climate change, including the costs of adaptation and mitigation under different policy scenarios (Czech Republic, Denmark, Finland, France, The Netherlands, United Kingdom).

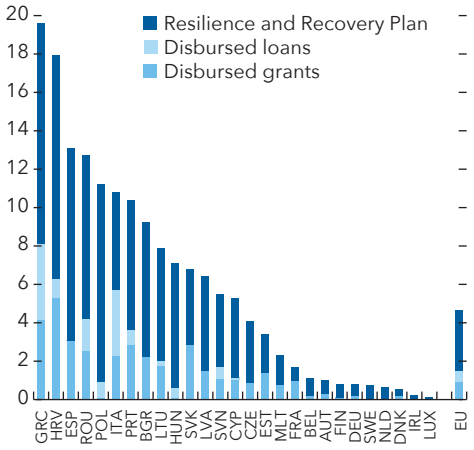
Box 3. Recovery and Resilience Facility Stock Take

The Recovery and Resilient Facility (RRF) is the core instrument (90 percent) of the NextGenerationEU pandemic recovery plan. Launched in 2021 and running until the end of 2026, the RRF aims to provide financing for investments and reforms of up to €800 billion to EU member states through a mix of grants and loans. The RRF is financed through the issuance of common EU bonds. The allocation is determined by differences in GDP per capita prepandemic and how hard countries were hit economically by the pandemic (Box Figure 3.1). Countries have developed detailed packages of investments and reforms in their national Recovery and Resilience Plans (RRPs), following a common methodology, with RRF disbursements tied to the completion of RRP targets.

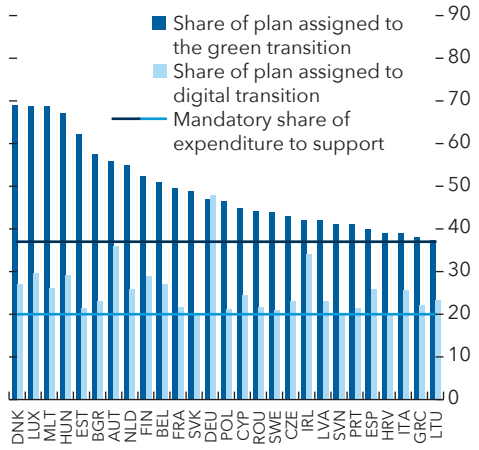
The performance-based approach of the RRF has been relatively successful at incentivizing reforms to address long-standing structural issues. Contrary to cost-based instruments such as cohesion funds, member states apply for payments from the RRF upon completion of reform and investment milestones and targets. For example, to receive funds, Spain implemented a significant labor market reform and Italy has taken steps to address backlogs in the justice system. At the end of 2023, about 75 percent of reforms planned to be done by that point had been completed.

The RRF has also helped to increase investments in priority areas for the European Union, including for the green and digital transitions. To align investments with EU priorities, countries must allocate at least 37 percent of the expenditures in their RRPs to measures contributing to climate objectives and at least 20 percent to measures for digitalization. Countries aim to overachieve these objectives in their RRPs (Box Figure 3.2). In the context of the REPowerEU plan, member states have introduced dedicated chapters in their RRP to obtain additional funding to diversify energy supplies, to reduce their reliance on Russian

Box Figure 3.1. RRF Grants and Loans Allocations and Disbursements
(Percent of 2019 GDP)



Box Figure 3.2. RRF Expenditure
(Percentage of total allocation; expenditure in RRPs)



Source: European Commission, AMECO database.
Note: Allocated amounts correspond to RRP. Disbursed funds as of the end of February 2024. In panel 2, only measures whose primary assignment is the green or digital transition are displayed. Mandatory share of expenditure to support green transition and digital transition are 37 percent and 20 percent, respectively. Country abbreviations are International Organization for Standardization (ISO) country codes. EU = European Union; RRF = Recovery and Resilient Facility; RRP = Recovery and Resilience Plan.

This box was prepared by Guillaume Claveres.

Box 3. *(continued)*

gas, and to accelerate the green transition. Overall, a significant share of public investment in the European Union is expected to be financed by the EU budget over 2019–25, particularly the RRF, according to the European Commission's autumn forecast, which projects public investment to maintain over the period contrary to the experience of past crises.

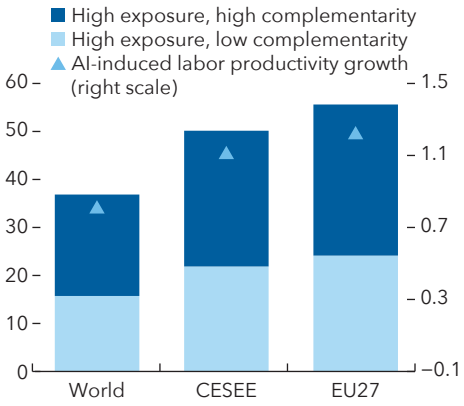
At the halfway point, the RRF has only disbursed about one-third of its funds (€225 billion), pointing to implementation challenges. Following a swift disbursement of close to €70 billion in prefinancing (prior to the completion of milestones and targets), the pace of disbursements slowed in 2023. Implementation challenges have included political difficulties related to reforms in some countries (for example, pension reform in Belgium and judicial reform in Poland), high inflation and supply chain disruptions, and administrative capacity constraints. The RRF is effective at combining reforms and investments under one framework, with countries designing their own plans, which boosts ownership. But countries have complained about the system's complexity and burdensome processes, calling for more flexibility in implementation and raising issues about overlapping EU reporting and control systems.

Faster and more effective implementation of reforms and investments will be key for the RRF to deliver its full macroeconomic impact. The extent to which that occurs will depend on strong reform implementation, a high additionality of spending, as well as addressing administrative capacity constraints and other challenges. Such challenges are particularly acute in countries with a poor track record in terms of absorbing EU funds, many of which also have large RRF allocations relative to their GDP. Accelerating progress on reforms and investments is critical to fully utilizing the available funds by the end of 2026, as unspent funds by that time will be lost. If the funds are fully absorbed, model-based estimates (European Commission 2024) suggest that NextGenerationEU has the potential to increase EU GDP by 1.4 percent in 2026, which includes significant spillovers as the RRF generates a coordinated fiscal impulse. For countries with large allocations, the impact is even higher—up to 4.5 percent in Greece or 3.5 percent in Romania and Spain. Such estimates are broadly in line with the IMF's earlier assessment of the RRF's macroeconomic impact, depending on the full utilization of the available funds (see IMF 2023b). As it focuses on reforms and investments, the RRF also has the potential to lift medium-term potential growth (Bańkowski and others 2022). The RRF also focuses on the green and digital transitions, but absorption has not been larger in these priority areas. Although 37 percent of the RRPs are supposed to be allocated to the green transition (20 percent for the digital transition), so far only 17 percent of the disbursed loans and grants excluding prefinancing have contributed to the green transition pillar (11 percent for the digital transition pillar).

Box 4. Artificial Intelligence and the Future of Work in Europe

The ongoing rapid progression of artificial intelligence (AI) has the potential to alter job dynamics and workers' productivity across various skill levels. Unlike previous waves of routine-biased automation that largely impacted lower-skilled (for example, clerical) workers, the labor market impact of AI could extend to higher-skilled workers (Pizzinelli and others 2023). While AI promises to elevate productivity and enhance income for some workers (for example, doctors and lawyers), it may concurrently harbor the risk of job obsolescence and diminished earning potential for others (for example, telemarketers).

Box Figure 4.1. Employment Shares by AI Exposure, Complementarity, and Productivity
(Percent)



Sources: Cazzaniga and others (2024); International Labor Organization; and IMF staff calculations.
Note: Employment share within each country group is calculated as the working-age population weighted average. EU27 includes Austria, Belarus, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Russia, Slovak Republic, Slovenia, Spain, and Sweden. AI = artificial intelligence; CESEE = Central, Eastern, and Southeastern Europe.

Recent IMF research (Cazzaniga and others, forthcoming) shows that about 60 percent of jobs across the European Union (only slightly lower, at over 50 percent, in the Central, Eastern, and Southeastern Europe region) are potentially exposed to AI (Box Figure 4.1). The good news is that more than half of exposed workers are likely to enjoy AI-induced productivity gains and the associated higher incomes. However, for the other half whose job tasks would become increasingly AI automatable and less complementary, widespread adoption of AI-based technologies would create job displacement risks and reduce earning potential, widening the existing productivity and income disparities within and across countries and delaying income convergence.

The extent to which countries, across the European Union and beyond, could leverage AI to the benefit of all depends on how well prepared they are to facilitate economy-wide adoption of AI-based technologies while mitigating the attendant risks. The IMF's new AI Preparedness Index (Box Figure 4.2) shows that there is strong heterogeneity in country-level readiness to harness AI across the European Union, ranging from a strong tech innovation ecosystem, a skilled labor force, and adaptable regulatory frameworks in Denmark, Estonia, and The Netherlands, to weak foundational AI infrastructure (for example, internet access) in Belarus and Montenegro.

Furthermore, the intersection of AI preparedness and exposure presents a multifaceted challenge for EU labor markets (Box Figure 4.3). In many advanced European economies, higher preparedness comes together with higher AI exposure. For example, in Denmark, Finland, France, and Germany, there is the risk of early job displacement alongside opportunities to boost productivity. Conversely, the Central, Eastern, and Southeastern Europe region is characterized by both lower exposure and lower preparedness for AI. The pace of AI adoption remains uncertain, but slow uptake on account of underpreparedness could mean missing an opportunity to narrow the productivity gap with higher-income EU peers. In a few European economies (for example, Cyprus and Slovenia), higher-than-average AI exposure is combined with lower-than-average preparedness, a potential source for concern.

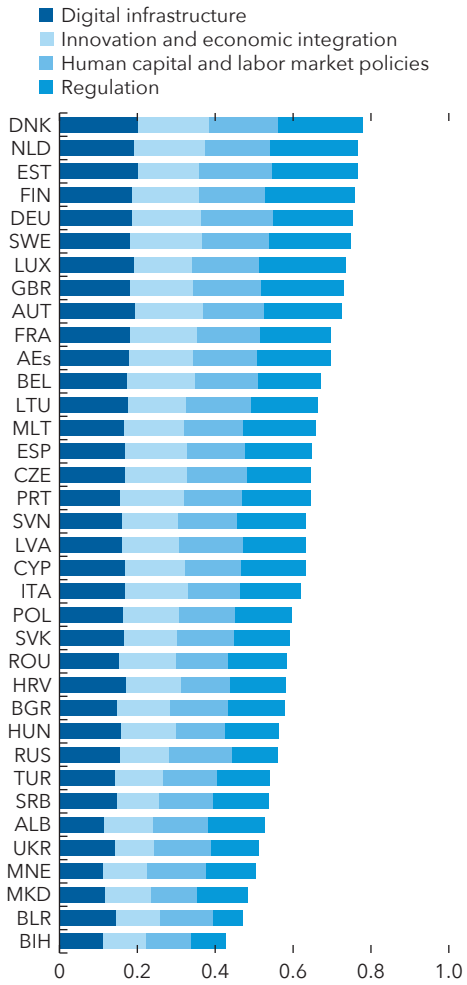
This box was prepared by Augustus Panton.

Box 4. *(continued)*

AI and its associated labor market transformations necessitate a targeted policy response. This includes strengthening social safety nets and the retraining of workers through upskilling and reskilling programs. Furthermore, the implementation of appropriate regulatory frameworks, such as those proposed in the EU AI Act, is crucial to encourage investment in digital innovation while addressing the risks inherent in widespread AI adoption. In emerging Europe, investments in foundational digital infrastructure and the development of a skilled labor force, with a greater emphasis on science, technology, engineering, and mathematics education, are essential.

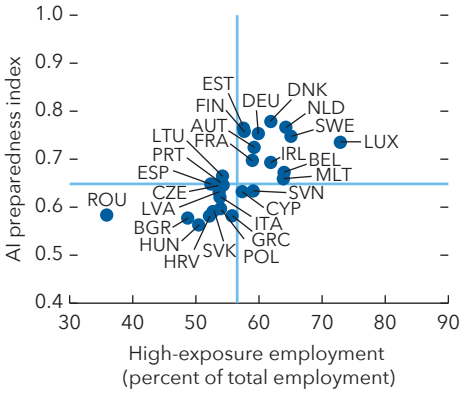
Box Figure 4.2. AI Preparedness Dimensions across Europe

(Percent of GDP)



Sources: Cazzaniga and others (2024); International Labor Organization; and IMF staff calculations.
Note: The figure shows the contribution of digital infrastructure, innovation and integration, human capital and policies, and regulation and ethics to AI preparedness by country. The length of the bar indicates AI preparedness score. Country abbreviations are International Organization for Standardization (ISO) country codes. AI = artificial intelligence.

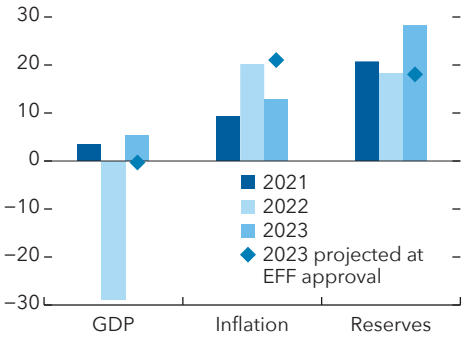
Box Figure 4.3. AI Preparedness and Employment Share in High-Exposure Occupations



Sources: Cazzaniga and others (2024); International Labor Organization; and IMF staff calculations.
Note: The blue reference lines are the median values of the AI preparedness index and high-exposure employment shares for EU-27. Country abbreviations are International Organization for Standardization (ISO) country codes. EU-27 includes Austria, Belarus, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Russia, Slovak Republic, Slovenia, Spain, and Sweden. AI = artificial intelligence.

Box 5. Ukraine's Economic Outturns: Resilience amid Adversity

Box Figure 5.1. Selected Economic Indicators
(Percent; reserves in billions of US dollars)



Source: IMF staff calculations.
Note: For GDP growth, the bar shows the projected range. EFF = Extended Fund Facility.

Russia's ongoing war in Ukraine has taken an enormous humanitarian and economic toll; according to the World Bank's latest Rapid Damage and Needs Assessment, total reconstruction costs are estimated at $486 billion (over twice as large as annual prewar GDP) over the next decade (World Bank 2024). Despite the war, Ukraine's economy has been resilient, as evidenced by recent macroeconomic outturns. This resilience stems primarily from a positive dynamic between the adaptability of households and firms in the face of the war, skillful policymaking, and a steady flow of external financing. Amid these challenges, Ukraine's performance under its Extended Fund Facility program, approved in March 2023, has remained strong, stemming from the authorities' commitment to wide-ranging structural reforms and implementation of sound policies under the program (Box Figure 5.1).

- *Growth*. Following a 28.8 percent decline in 2022, Ukraine experienced an estimated output growth of 5.3 percent in 2023, significantly outperforming the projected –3 to 1 percent range at Extended Fund Facility approval. This reflects the adaptability of households and firms to wartime conditions, swift recovery from damages to energy infrastructure through prompt repairs, as well as a strong harvest and the expansion of alternative export routes following the mid-2023 closure of the Black Sea Grain Initiative. The resilience of the energy landscape has reflected ramped up domestic gas production and storage, securing electricity imports from neighboring countries when needed, and a somewhat mild winter; however, the sector has faced renewed pressure from Russian attacks in late March 2024. Additionally, improvements in the labor market, including due to the slowing pace of outward migration, have also helped support activity, though strains from labor shortages remain, including due to military uptake.
- *Inflation and foreign exchange market*. Inflation has been reined in, falling from a high of 26.6 percent at the end of 2022 to 3.2 percent in March 2024, reaching the National Bank of Ukraine's target range of 5±1 percent. This reflects both external and domestic factors, including better food supply from the strong harvest, easing supply constraints, well-anchored expectations supported by measured monetary policy easing, and stability in the foreign exchange market. On the latter, the National Bank of Ukraine transitioned smoothly from a fixed to a managed exchange rate regime in October 2023, in line with its conditions-based strategy (National Bank of Ukraine 2023). Substantial external financing ($42.5 billion in 2023) helped lift foreign exchange reserves to $44 billion (over five months of prospective imports) at the end of March 2024.
- *Fiscal position*. The overall fiscal deficit was sizable at 19.7 percent of GDP in 2023, but in line with expectations at the time of the program's approval. The deficit reflects high expenditures (nearly 75 percent of GDP), given the realities of the war and despite tight control over nondefense expenditures. Strong international support, including through substantial grant financing, boosted revenues, which were around 55 percent of GDP.

This box was prepared by Sidra Rehman.

Box 5. *(continued)*

- *Current account*. Higher imports from stronger domestic demand as well as weaker exports impeded by capacity constraints and logistical bottlenecks resulted in a current account deficit of 5.5 percent of GDP in 2023 from a surplus in 2022. Alternative trade routes and substantial grant financing helped limit the impact on the current account.
- *Financial sector*. The financial system remains stable and liquid. Credit contraction is bottoming out, buoyed by credit support schemes (especially the 5-7-9 program with capped interest rates for small and medium enterprises), and a nascent revival in loan demand (particularly for affordable housing mortgages as the economy recovers.
- *Program performance and key reforms*. In March 2024, Ukraine successfully completed the Third Review under the Extended Fund Facility, enabling a disbursement of $880 million and bringing IMF support to $5.4 billion (IMF 2024). Despite the continuing challenges of wartime as well as recent delays in external financing, program performance since approval has remained robust, with the authorities meeting most quantitative targets and structural benchmarks. Key reforms include those to strengthen anticorruption and governance; revenue mobilization, medium-term budgeting, fiscal risk management, and public investment management; and financial sector stability.

Despite its resilience, the economy still faces strong headwinds, and downside risks remain exceptionally high. The baseline outlook entails a softening in the sequential recovery in 2024, although the headwinds to growth should be temporary assuming that the war winds down by the end of 2024. Medium-term prospects are supported by returns from structural reforms in the context of the EU accession path. At the same time, downside risks to the outlook remain exceptionally high particularly due to prolonged war-related uncertainties and potential shortfalls in external financing which could result in suboptimal policy choices if shocks materialize.

Looking ahead, maintaining policy and reform momentum as well as external financing remain critical for sustaining progress. Ukraine's recent economic performance underscores the criticality of maintaining agile policymaking and the strong reform momentum, together with the timely disbursement of committed external financing. This will help safeguard Ukraine's hard won macroeconomic stability, restore fiscal and debt sustainability, and lay the groundwork for reconstruction and the path to EU accession.

Box 6. Russia

Over the past two years and amid large-scale sanctions imposed by a host of countries, the Russian economy has proven resilient.

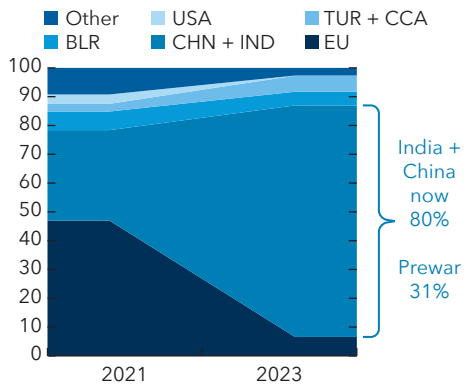
Following a relatively mild contraction of 1.2 percent in 2022, the economy again outperformed expectations in 2023, growing by 3.6 percent (Box Table 6.1). A few factors explain this resilience. First, while exports have fallen, the decline has been mitigated by the fact that oil export volumes have been very steady despite sanctions. This is because the oil that used to go to Europe is now being absorbed elsewhere, notably China and India (Box Figure 6.1).

Box Table 6.1. Contributions to GDP Growth

	2020	2021	2022	2023
GDP	**–2.7**	**6.0**	**–1.2**	**3.6**
Private Consumption	–3.0	6.1	–0.6	2.9
Public Consumption	0.4	0.4	0.5	0.6
Gross Capital Formation	–1.0	2.8	0.3	4.5
Net Exports	1.3	–3.1	–1.1	N/A

Sources: Federal State Statistics Service for the Russian Federation; Haver Analytics; and IMF staff calculations.
Note: N/A = not available.

Box Figure 6.1. Russian Crude Oil-Purchasing Countries
(Percent of Russia's total crude exports)



Sources: Federal Communications Commission; International Energy Agency; Kpler; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes. EU = European Union.

With global oil prices still elevated and the discount on Russian oil lower than at the beginning of the war despite the price cap, oil export revenues remain high and bolster the economy. Second, corporate investment has recovered from the drop in 2022, adding 4.5 percentage points to the growth in GDP in 2023. Investment is being bolstered by increased resources flowing to the defense and manufacturing sectors. In addition, the sanctions imposed after the start of the invasion of Ukraine have made a retooling of the economy necessary. For instance, some imports are being substituted by domestic goods, resulting in investments in new production facilities. Third, private consumption has recovered strongly, adding 2.9 percentage points to GDP growth. This is being driven by buoyant credit and a strong labor market, with record low unemployment of just 3 percent and rising wages.

This box was prepared by Philipp Engler.

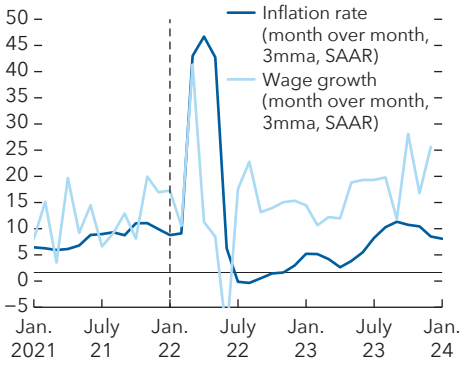
Box 6. *(continued)*

Fourth, government spending has also added to growth but more modestly, with the fiscal impulse estimated at 1.2 percentage points of GDP in 2023.[1] Despite a large increase in military spending, overall government spending has increased but not as much in real terms.

The economy is not projected to keep growing at the same pace as in 2023. There are some signs of overheating, which can be seen in record-low unemployment, elevated rates of inflation, and the fact that wages are growing fast (Box Figure 6.2), to which the Bank of Russia has reacted by raising its policy rate from 7.5 percent to 16 percent in the course of the second half of last year. The tightening of monetary policy, plus the projected withdrawal of fiscal stimulus (Box Figure 6.3), are expected to weigh on growth going forward. The IMF staff therefore projects quarterly growth to decelerate to around 2.6 percent annualized throughout the year.[2] The uncertainty around this baseline forecast is large, though. In particular, the recent tightening of sanctions since December could have a material impact on growth, though at this stage it is too early to tell.

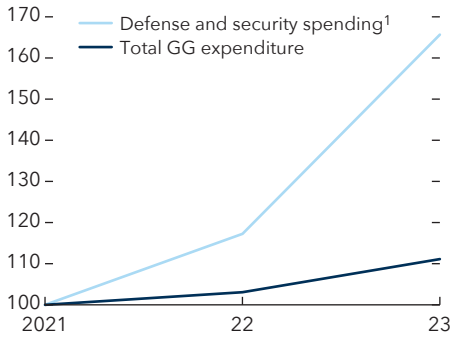
Similarly, we project modest growth in the medium term amid a shrinking labor force due to an aging population, loss in human capital, isolation from global financial markets, and impaired access to advanced technology related to Western sanctions that will harm productivity growth. Potential growth is projected to fall to around 1¼ percent, versus 1.7 percent before the war. This would mean that Russia's income per capita may no longer converge toward Western European levels in the medium to long term. All these projections, however, remain surrounded by large uncertainty, as it is not easy to quantify the factors mentioned in this box.

Box Figure 6.2. Inflation Rate and Wage Growth
(Percent)



Sources: Federal State Statistics Service for the Russian Federation; Haver Analytics; and IMF staff calculations.
Note: 3mma = three-month moving average; SAAR = seasonally adjusted annual rate.

Box Figure 6.3. Real General Government Expenditure
(Index, 2021 = 100)



Source: Authorities.
Note: GG = general government.
[1]Based on H1 data; includes classified spending.

[1] This at least when measured at the level of the general government. State-owned enterprises have a large footprint in Russia, and there is less visibility on their recent spending.

[2] The much higher annual growth rate of 3.2 percent reflects strong carryover effects related to fast growth in the second half of 2023.

Annex Table 1.1 Real GDP Growth

(Year-over-year percent change; aggregation based on GDP in purchasing power parity terms)

		April 2024 WEO			October 2023 WEO			Difference		
	2023	2024	2025	2026	2024	2025	2026	2024	2025	2026
Europe	1.4	1.6	2.0	1.9	1.5	2.1	2.0	0.1	–0.1	–0.1
Advanced European Economies	0.5	0.8	1.6	1.6	1.2	1.9	1.8	–0.4	–0.3	–0.2
Euro Area	0.4	0.8	1.5	1.4	1.2	1.8	1.7	–0.4	–0.3	–0.3
Austria	–0.7	0.4	1.6	1.4	0.8	1.7	1.9	–0.4	–0.1	–0.5
Belgium	1.5	1.2	1.2	1.2	0.9	1.2	1.2	0.3	0.0	0.0
Croatia	2.8	3.0	2.7	2.7	2.6	2.7	2.9	0.4	0.0	–0.2
Cyprus	2.5	2.7	2.9	3.0	2.7	3.0	3.0	0.0	–0.1	0.0
Estonia	–3.0	–0.5	2.2	2.0	2.4	2.7	2.9	–2.9	–0.5	–0.9
Finland	–1.0	0.4	1.9	1.9	1.0	1.3	1.6	–0.6	0.6	0.3
France	0.9	0.7	1.4	1.6	1.3	1.8	1.7	–0.6	–0.4	–0.1
Germany	–0.3	0.2	1.3	1.5	0.9	2.0	1.9	–0.7	–0.7	–0.4
Greece	2.0	2.0	1.9	1.7	2.0	1.4	1.4	0.0	0.5	0.3
Ireland	–3.2	1.5	2.5	2.5	3.3	3.2	2.7	–1.8	–0.7	–0.2
Italy	0.9	0.7	0.7	0.2	0.7	1.0	1.1	0.0	–0.3	–0.9
Latvia	–0.3	1.7	2.4	2.5	2.6	3.2	3.2	–0.9	–0.8	–0.7
Lithuania	–0.3	2.2	2.5	2.3	2.7	2.6	2.5	–0.5	–0.1	–0.2
Luxembourg	–1.1	1.3	2.9	2.5	1.5	2.4	2.5	–0.2	0.5	0.0
Malta	5.6	5.0	4.0	3.6	3.3	3.5	3.5	1.7	0.5	0.1
Netherlands, The	0.1	0.6	1.3	1.9	1.1	1.5	1.6	–0.5	–0.2	0.3
Portugal	2.3	1.7	2.1	2.0	1.5	2.1	2.0	0.2	0.0	0.0
Slovak Republic	1.1	2.1	2.6	2.8	2.5	2.8	2.8	–0.4	–0.2	0.0
Slovenia	1.6	2.0	2.5	2.7	2.2	2.6	2.8	–0.2	–0.1	–0.1
Spain	2.5	1.9	2.1	1.8	1.7	2.1	1.8	0.2	0.0	0.0
Nordic Economies	0.6	1.1	1.9	1.9	1.1	1.7	1.7	0.0	0.2	0.2
Denmark	1.8	2.1	1.5	1.5	1.4	1.2	1.3	0.7	0.3	0.2
Iceland	4.1	1.7	2.0	2.2	1.7	2.2	2.4	0.0	–0.2	–0.2
Norway	0.5	1.5	1.9	1.7	1.5	1.2	1.5	0.0	0.7	0.2
Sweden	–0.2	0.2	2.2	2.2	0.6	2.4	2.2	–0.4	–0.2	0.0
Other European Advanced Economies	0.3	0.7	1.9	1.9	1.2	2.1	2.2	–0.5	–0.2	–0.3
Andorra	2.3	1.8	1.5	1.5	1.5	1.5	1.5	0.3	0.0	0.0
Czech Republic	–0.4	0.7	2.0	2.1	2.3	2.9	2.7	–1.6	–0.9	–0.6
Israel	2.0	1.6	5.4	3.1	3.0	3.3	3.6	–1.4	2.1	–0.5
San Marino	2.3	1.3	1.3	1.3	1.3	1.3	1.3	0.0	0.0	0.0
Switzerland	0.8	1.3	1.4	1.8	1.8	1.2	1.8	–0.5	0.2	0.0
United Kingdom	0.1	0.5	1.5	1.7	0.6	2.0	2.0	–0.1	–0.5	–0.3

	April 2024 WEO				October 2023 WEO			Difference		
	2023	2024	2025	2026	2024	2025	2026	2024	2025	2026
European Emerging Market Economies	3.2	3.1	2.8	2.6	2.2	2.5	2.5	0.9	0.3	0.1
Central Europe	–0.1	2.9	3.5	3.2	2.4	3.4	3.3	0.5	0.1	–0.1
Hungary	–0.9	2.2	3.3	2.8	3.1	3.3	3.4	–0.9	0.0	–0.6
Poland	0.2	3.1	3.5	3.3	2.3	3.4	3.2	0.8	0.1	0.1
Eastern Europe	3.7	3.1	2.2	1.6	1.3	1.5	1.3	1.8	0.7	0.3
Belarus	3.9	2.4	1.1	1.3	1.3	0.6	0.7	1.1	0.5	0.6
Moldova	1.0	2.6	4.8	5.0	4.3	5.0	5.0	–1.7	–0.2	0.0
Russia	3.6	3.2	1.8	1.2	1.1	1.0	1.0	2.1	0.8	0.2
Ukraine	5.0	3.2	6.5	5.0	3.2	6.5	5.0	0.0	0.0	0.0
Southeastern European EU Member States	2.1	2.8	3.5	3.7	3.7	3.7	3.7	–0.9	–0.2	0.0
Bulgaria	1.8	2.7	2.9	2.9	3.2	3.0	2.9	–0.5	–0.1	0.0
Romania	2.1	2.8	3.6	3.8	3.8	3.8	3.8	–1.0	–0.2	0.0
Southeastern European Non–EU Member States	2.6	3.2	3.9	3.7	3.2	3.9	3.6	0.0	0.0	0.1
Albania	3.3	3.1	3.4	3.5	3.3	3.4	3.5	–0.2	0.0	0.0
Bosnia and Herzegovina	1.8	2.5	3.0	3.0	3.0	3.0	3.0	–0.5	0.0	0.0
Kosovo	3.3	3.8	4.0	3.9	4.0	4.0	3.9	–0.2	0.0	0.0
Montenegro	6.0	3.7	3.0	3.0	3.7	3.2	3.0	0.0	–0.2	0.0
North Macedonia	1.0	2.7	3.7	3.9	3.2	3.5	3.5	–0.5	0.2	0.4
Serbia	2.5	3.5	4.5	4.0	3.0	4.5	4.0	0.5	0.0	0.0
Türkiye	4.5	3.1	3.2	3.3	3.0	3.2	3.2	0.1	0.0	0.1
Memorandum										
World	3.2	3.2	3.2	3.2	2.9	3.2	3.2	0.3	0.0	0.0
Advanced Economies	1.6	1.7	1.8	1.8	1.4	1.8	1.9	0.3	0.0	–0.1
Emerging Market and Developing Economies	4.3	4.2	4.2	4.1	4.0	4.1	4.1	0.2	0.1	0.0
Emerging and Developing Europe	3.2	3.1	2.8	2.6	2.2	2.5	2.5	0.9	0.3	0.1
European Emerging Market Economies, excluding Belarus, Russia, Türkiye, and Ukraine	0.8	2.9	3.5	3.4	2.9	3.5	3.4	0.0	0.0	0.0
European Union	0.6	1.1	1.8	1.7	1.5	2.1	2.0	–0.4	–0.3	–0.3
United States	2.5	2.7	1.9	2.0	1.5	1.8	2.1	1.2	0.1	–0.1
China	5.2	4.6	4.1	3.8	4.2	4.1	4.1	0.4	0.0	–0.3
Japan	1.9	0.9	1.0	0.8	1.0	0.6	0.5	–0.1	0.4	0.3

Sources: IMF, World Economic Outlook (WEO) database; and IMF staff calculations.

Annex Table 1.2. Headline Inflation

(Year-over-year percent change; aggregation based on GDP in purchasing power parity terms)

		April 2024 WEO			October 2023 WEO			Difference		
	2023	2024	2025	2026	2024	2025	2026	2024	2025	2026
Europe	10.5	8.4	6.0	4.3	9.3	7.2	6.7	–0.9	–1.2	–2.4
Advanced European Economies	5.6	2.4	2.1	1.9	3.3	2.2	2.0	–0.9	–0.1	–0.1
Euro Area	5.4	2.4	2.1	2.0	3.3	2.2	2.0	–0.9	–0.1	0.0
Austria	7.7	3.9	2.8	2.3	3.7	2.5	2.1	0.2	0.3	0.2
Belgium	2.3	3.6	2.0	1.9	4.3	2.1	1.8	–0.7	–0.1	0.1
Croatia	8.4	3.7	2.2	2.2	4.2	2.5	2.2	–0.5	–0.3	0.0
Cyprus	3.9	2.3	2.0	2.0	2.4	2.2	2.1	–0.1	–0.2	–0.1
Estonia	9.1	4.2	2.5	2.5	3.8	3.2	2.8	0.4	–0.7	–0.3
Finland	4.3	1.2	1.9	2.0	1.9	2.0	2.0	–0.7	–0.1	0.0
France	5.7	2.4	1.8	1.8	2.5	2.0	2.0	–0.1	–0.2	–0.2
Germany	6.0	2.4	2.0	2.0	3.5	2.2	2.1	–1.1	–0.2	–0.1
Greece	4.2	2.7	2.1	2.0	2.8	2.2	2.0	–0.1	–0.1	0.0
Ireland	5.2	2.4	2.0	2.0	3.0	2.4	2.0	–0.6	–0.4	0.0
Italy	5.9	1.7	2.0	2.0	2.6	2.2	2.0	–0.9	–0.2	0.0
Latvia	9.1	2.0	3.6	2.2	4.2	3.3	2.4	–2.2	0.3	–0.2
Lithuania	8.7	1.5	2.3	2.2	3.9	3.0	2.8	–2.4	–0.7	–0.6
Luxembourg	2.9	2.5	3.1	2.1	3.3	2.2	2.0	–0.8	0.9	0.1
Malta	5.7	2.9	2.1	2.0	3.1	2.2	2.0	–0.2	–0.1	0.0
Netherlands, The	4.1	2.7	2.1	2.0	4.2	2.2	2.0	–1.5	–0.1	0.0
Portugal	5.3	2.2	2.0	2.0	3.4	2.4	2.2	–1.2	–0.4	–0.2
Slovak Republic	11.0	3.6	3.9	2.5	4.8	2.3	1.9	–1.2	1.6	0.6
Slovenia	7.4	2.7	2.0	2.0	4.2	3.1	2.4	–1.5	–1.1	–0.4
Spain	3.4	2.7	2.4	1.9	3.9	2.1	1.8	–1.2	0.3	0.1
Nordic Economies	5.2	2.5	2.2	2.0	3.4	2.5	2.2	–0.9	–0.3	–0.2
Denmark	3.4	1.5	2.0	2.0	2.8	2.1	2.1	–1.3	–0.1	–0.1
Iceland	8.7	5.6	3.4	2.5	4.5	3.6	2.6	1.1	–0.2	–0.1
Norway	5.5	3.3	2.6	2.0	3.7	2.6	2.0	–0.4	0.0	0.0
Sweden	5.9	2.6	2.0	2.0	3.6	2.7	2.3	–1.0	–0.7	–0.3
Other European Advanced Economies	6.6	2.3	2.0	1.9	3.5	2.1	2.0	–1.2	–0.1	–0.1
Andorra	5.6	4.3	2.4	2.1	3.5	2.0	1.7	0.8	0.4	0.4
Czech Republic	10.7	2.1	2.0	2.0	4.6	2.1	2.0	–2.5	–0.1	0.0
Israel	4.2	2.4	2.5	2.1	3.0	2.5	2.3	–0.6	0.0	–0.2
San Marino	6.1	2.3	2.0	2.0	2.5	2.0	2.0	–0.2	0.0	0.0
Switzerland	2.1	1.5	1.2	1.2	2.0	1.7	1.5	–0.5	–0.5	–0.3
United Kingdom	7.3	2.5	2.0	2.0	3.7	2.1	2.0	–1.2	–0.1	0.0

	April 2024 WEO				October 2023 WEO			Difference		
	2023	2024	2025	2026	2024	2025	2026	2024	2025	2026
European Emerging Market Economies	21.0	20.9	14.1	9.1	22.3	17.9	16.6	–1.4	–3.8	–7.5
Central Europe	12.5	4.8	4.7	3.5	6.4	4.5	3.7	–1.6	0.2	–0.2
Hungary	17.1	3.7	3.5	2.9	6.6	4.3	3.8	–2.9	–0.8	–0.9
Poland	11.4	5.0	5.0	3.6	6.4	4.5	3.6	–1.4	0.5	0.0
Eastern Europe	6.5	6.8	4.9	4.3	6.9	4.4	4.3	–0.1	0.5	0.0
Belarus	5.0	6.3	6.5	5.9	5.7	4.2	5.0	0.6	2.3	0.9
Moldova	13.4	5.0	5.0	5.0	5.0	5.0	5.0	0.0	0.0	0.0
Russia	5.9	6.9	4.5	4.0	6.3	4.0	4.0	0.6	0.5	0.0
Ukraine	12.9	6.4	7.6	6.2	13.0	8.6	6.7	–6.6	–1.0	–0.5
Southeastern European EU Member States	10.0	5.5	3.8	3.1	5.2	3.3	3.3	0.3	0.5	–0.2
Bulgaria	8.6	3.4	2.7	2.2	3.0	2.1	2.0	0.4	0.6	0.2
Romania	10.4	6.0	4.0	3.3	5.8	3.6	3.6	0.2	0.4	–0.3
Southeastern European Non–EU Member States	9.2	4.1	2.9	2.7	4.4	3.1	2.8	–0.3	–0.2	–0.1
Albania	4.8	3.5	3.0	3.0	4.0	3.2	3.0	–0.5	–0.2	0.0
Bosnia and Herzegovina	6.1	3.0	2.7	2.5	3.0	2.7	2.5	0.0	0.0	0.0
Kosovo	5.2	3.5	2.3	1.9	3.1	2.3	1.9	0.4	0.0	0.0
Montenegro	8.6	4.2	2.7	2.1	4.3	2.6	2.1	–0.1	0.1	0.0
North Macedonia	9.4	4.0	2.5	2.0	4.3	2.2	2.0	–0.3	0.3	0.0
Serbia	12.4	4.8	3.1	3.0	5.3	3.5	3.2	–0.5	–0.4	–0.2
Türkiye	53.9	59.5	38.4	22.4	62.5	52.5	48.1	–3.0	–14.1	–25.7
Memorandum										
World	6.8	5.9	4.5	3.7	5.8	4.6	4.2	0.1	–0.1	–0.5
Advanced Economies	4.6	2.6	2.0	2.0	3.0	2.2	2.0	–0.4	–0.2	0.0
Emerging Market and Developing Economies	8.3	8.3	6.2	4.9	7.8	6.2	5.7	0.5	0.0	–0.8
Emerging and Developing Europe	19.4	18.8	13.1	8.8	19.9	16.1	15.0	–1.1	–3.0	–6.2
European Emerging Market Economies, excluding Belarus, Russia, Türkiye, and Ukraine	11.5	4.9	4.2	3.3	5.8	4.0	3.5	–0.9	0.2	–0.2
European Union	6.3	2.7	2.4	2.1	3.6	2.4	2.2	–0.9	0.0	–0.1
United States	4.1	2.9	2.0	2.1	2.8	2.4	2.2	0.1	–0.4	–0.1
China	0.2	1.0	2.0	2.0	1.7	2.2	2.2	–0.7	–0.2	–0.2
Japan	3.3	2.2	2.1	2.0	2.9	1.9	1.6	–0.7	0.2	0.4

Sources: IMF, World Economic Outlook (WEO) database; and IMF staff calculations.

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PUBLICATIONS

REGIONAL ECONOMIC OUTLOOK
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